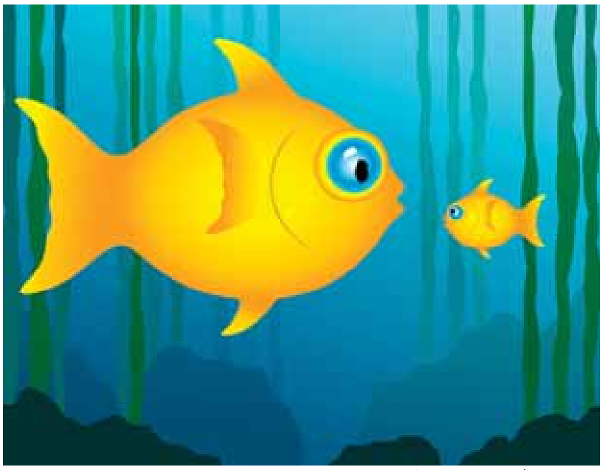
Large and diversified entities

Does size matter?



Courtesy: Wordpress.com

The paints and coatings industry has a long history of Mergers & Acquisitions (M&As), driven primarily by the search for strategic positioning in the industry. The economic slowdown of 2008-09 prompted a restructuring of the chemical and allied industries, with companies having posted good profitability in the face of massive cost reduction. Countries in the West have witnessed a long period of economic downturn, while Asia continued to grow. At the same time, this has also given way for a major rethink, from a cost perspective as well as strategic positioning and product development.

■ Dr Mosongo Moukwa

The necessity for survival has led to huge improvement in operations of the chemical and allied industries. Now that cost realignments have helped bring profits back to healthy levels, strategic buyers have a greater appetite to make deals. Companies have come out much more profitable and disciplined on the top line in a continually changing world. Asia is slowly emerging as a new chemical producing region, and producers in the West have set their sight here.

While they are migrating East, new players in China, India and the Middle East are emerging, emboldened by the economical resilience shown by Asia, whereas some are capitalising on the growth witnessed in the region. It is expected that some will compete head-on with companies based in the West for a greater share of the Asian market.

M&As gain momentum

M&As have resumed, but companies are being deliberate. BASF's strategy is to 'We want to make our portfolio more competitive and cyclically resilient', according to the Chairman of the company. This effectively lays out the roadmap for specialty and diversified chemical makers who will continue to move away from commodity businesses where they do not have clear advantages.

Chemical companies will look to gain access to these booming developing world markets. Moving into new markets requires financial backup, and hence companies can take new risks. There are questions of intellectual property protection, people and capital. They also have to face other issues associated with a more centrally planned and controlled economy. The rise of China as a great exporting nation has been a blessing for consumers in the rest of the world. It has, however, posed a hurdle for producers, especially for those in direct competition from Chinese producers.

Companies have or will face the following dilemma: should they be afraid, or fight with their superior innovation that could keep them ahead. This dilemma was acute in the textile industry, which is now dominated by Asian manufacturers, with 60 per cent of the world synthetic fibre capacity located today in China. Will this dilemma present itself to chemical manufacturers? It is our belief that this head-on competition will become acute even in the chemical industry in the near future. How companies will respond to the anticipated new scenario will determine the future of the industry.

The textile industry has taught us a few strategic lessons applicable to the chemicals and coatings industries. The case of Lenzing, an Austrian company, illustrates how one can survive in a turbulent industry in the face of fierce Asian competition, particularly from China. The case also shows that large diversified groups are not always best-placed to deal with rising international competition.

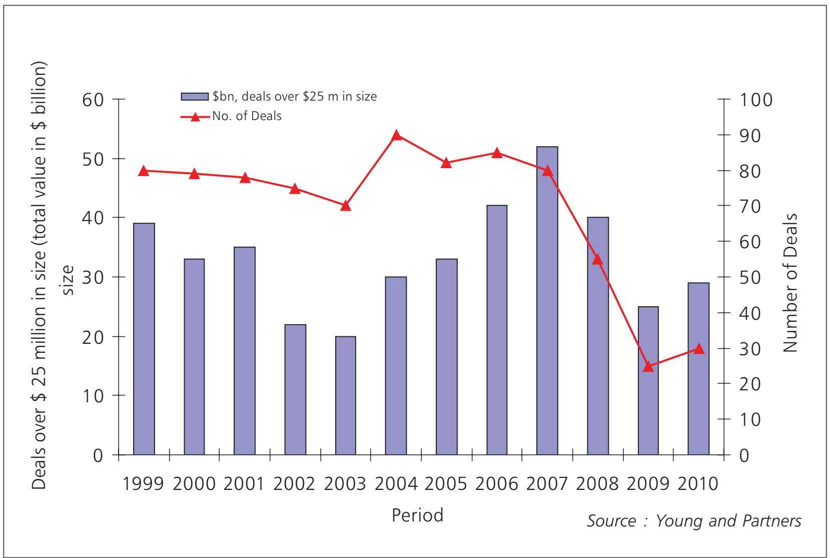


Figure 1: Acquisition of worldwide companies

Lenzing: A case study

This is a David and Goliath story. Lenzing has survived as a key player in the textile industry, not only in Europe but also in Asia. The company has recently announced an expansion of its plants in China & Indonesia and a third site planned in India. It has done this in a sector of the industry - cellulosic fibres derived from woodpulp - which include rayon that was once thought doomed to decline.

The rise of Lenzing is a triumph of specialisation. It highlights why large diversified groups are not always best-placed to deal with rising international competition. The Goliath in this case was Courtaulds, the UK-based company that pioneered the development of rayon before the First World War, but now no longer exists.

Courtesy: Napper Services

The textile industry has taught us a few strategic lessons applicable to the chemicals and coatings industries.

When the original Lenzing plant was set up in 1938, Courtaulds was the industry giant. However, DuPont had just invented nylon, opening a new line of research that posed a threat to Courtaulds' main source of profit. Nylon, polyester and acrylic fibre were synthesised through polymer chemistry, and the leading producers were chemical companies such as DuPont, Hoechst and ICI. These fibres were more versatile than rayon and had easy-care properties, which cotton & wool could not match.

How to reduce its dependence on rayon was a postwar preoccupation for Courtaulds. By 1960, it had its own acrylic fibre (*Courtelle*) and was making nylon on a small-scale basis; it had also diversified into other directions, including paints. Lenzing, in contrast, remained more dependent on its core business of cellulosic fibre.

During the 1960s and 1970s, Courtaulds continued to diversify, principally into textiles and clothing. The strategy was driven by Frank Kearton, who believed that through scale and new technologies, textiles in the UK would cease to be a declining industry, but will have every prospect of becoming a growth industry once again.

By 1975, Courtaulds was a much bigger company, with a substantial stake in fibres, including rayon. But the viscose process by which rayon was made caused environmental damage, which was no longer acceptable in many countries. So, the producers had to decide whether to spend large amount of money to clean up the process or to withdraw. Courtaulds chose to stick with rayon but also decided to work on a novel cellulosic fibre, made by a process known as solvent spinning.

This research began in 1979 and by the end of that year, Christopher Hogg was appointed CEO. His task was to bring order into the empire that Kreaton had created. The investment in textiles had proven to be a serious error, mainly because of rising imports from low-wage suppliers and this group needed a great deal of sorting out. Hogg eventually demerged it as Courtaulds Textiles in 1990.

After the demerger, Courtaulds was still a diversified company. The paints subsidiary, which had been expanded by further acquisitions, looked to offer the best prospects for growth. But the question was: would it make sense to get out of fibres with the continuing contraction of the European textile industry? An argument for not doing so was the progress that its researchers had made with solvent spinning. They had shown that the process was pollution-free; the fibre coming out of it, which was given the brand name *Tencel* (tenacity and cellulose), was stronger than rayon and could be used to make finer yarns & lighter fabrics.

The first *Tencel* plant (in Mobile, Alabama (US)), came on stream in 1992, and the initial response was enthusiastic. However, partly because of the issues in quality in converting yarn into fabric, the market developed on a slow pace than Courtaulds had expected. By the second half of the 1990s, the company found itself in financial trouble. It was spending heavily on the new fibre, but not generating enough revenue in the rest of the group. With the share price under pressure, Courtaulds was vulnerable to a break up bid and in 1998, AkzoNobel, the Netherlands, bought the company.

After the takeover, AkzoNobel retained only Courtaulds paints division. The fibres side was bought by CVC, a private equity firm, which sold the *Tencel* business to Lenzing in 2004. The Austrian company was by then producing its own solvent spun fibre, but Thomas Fahnemann, an ex-Hoechst Manager who had recently been appointed CEO, believed that buying Courtaulds' plants would give Lenzing a dominant position in a promising sector of the market. He was right. While *Tencel* has not become a mainstream fibre, it has achieved part of what the proponents of the project in Courtaulds had hoped for. Although expensive, compared to cotton or polyester, it was used in high-end garments where its exceptional softness and drape were valued. It also had the advantage of 'greenness'.

As a cellulosic specialist, Lenzing was a logical home for the next fibre. Cellulosic fibres, of which rayon is still the most important, represent only 5 per cent of the world fibre market. But, they have some properties, notably absorbency, which the oil-based synthetics lack. As a textile fibre, rayon has recovered some lost ground

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in the recent years. Thanks to the strong demand in China, cellulosics are widely used in advanced industrial countries in non-woven applications. Despite of strong competition from Asian producers, Lenzing is well-placed to serve both markets.

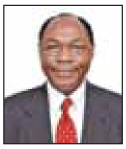
Moral of the story

From the Lenzing story, it can be understood that large diversified companies are not necessarily better equipped to withstand international competition than small, specialised ones. There are perils in trying to do too many things. Another is that, rapid changes of direction such as Kreaton's plunge into textiles and clothing, can have disastrous consequences.

Courtesy: Nordson Industrial Coating

Companies are generally well-advised to concentrate on what they are best at, and build from there. The strategic consideration for specialty companies would be to not only address the emerging markets, but also to understand new applications, staying ahead of the curve and protecting technology assets.

M&As in the chemical industry are always of great interest to the coatings manufacturers. The ultimate question is what impact M&As in the chemical industry (both upstream and downstream), would have on the coatings sector when new Asian giants in the global village come to be. This question still remains unanswered. What is certain is that, this will surely create a new path for the paints & coatings industry. ■



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