Chemicals companies must shed old habits and adopt new strategies.
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The chemicals industry faced significant headwinds in 2015: a strong dollar, slowing emerging economies, malaise in Brazil, stagnation in Europe and Japan, and a cyclical downturn in the agricultural sector. In addition to having to operate in an unfavorable economic environment, many chemicals companies also found themselves the target of activist investor campaigns last year. Among the companies feeling pressure were Air Products, American Pacific, Calgon Carbon, Ferro Corporation, LSB Industries (Engine Capital), and OMNOVA Solutions. Activist investors also fostered the largest chemicals industry transaction of 2015, the merger of DuPont and Dow Chemical.

A recurring theme for most of the activist investors was the lack of a compelling rationale or coherence in the existing portfolio of target businesses. As a result, many chemicals companies began to reconsider their product lines, sometimes as part of a merger or acquisition. The large and growing firepower accumulated by activist funds — which had US$169 billion under management in mid-2015, according to FTI Consulting, up from $93 billion in January, 2014 — suggests that shareholder activism will continue to be a factor in the industry in 2016.

As a result, if you are a chemicals executive, don’t expect the coming year to be any less challenging than the last few. You can expect that three particular issues — business portfolio coherence, next-generation productivity, and digital transformation — will be at the top of your agenda in the next 12 months.
In general, investment interest in the chemicals industry is surging because of an ongoing dynamic: consolidation around more coherent business portfolios. Activists perceive a lack of clarity and logic in company asset portfolios, which grew disjointed as firms pursued two strategic approaches for too long: (1) chasing existing molecules into new stages of the value chain; and (2) entering new product lines, a move that was often justified by the company’s presence in an adjacent or similar customer segment.

These strategies seemed to make sense for a time. But as the maturity cycle in segments of the chemicals industry sped up and the value chain became increasingly commoditized, this approach began to backfire. For example, in the early stages of PVC development, it might have been possible for a PVC resin producer to expand its profit potential by owning its own fabrication businesses. However, over time a more transparent and heavily populated PVC producer market developed, and the benefits of vertical integration became less apparent as viable stand-alone fabrication competitors emerged.

Similarly, when specialty products were “special,” bundling different product lines was advantageous, particularly for chemicals companies whose specialty items were in strong demand. They could use the strength of best-selling products to squeeze increased sales and profits out of their other lines. For example, a plastics additive provider with a popular (and unique) heat stabilizer compound might assemble a related but disparate portfolio that also included UV stabilizers and antioxidants. But as many specialty chemicals lost their one-of-a-kind privileges as low-cost suppliers entered these product lines, the new competitive realities emboldened customer procurement departments to demand ever-greater control over their orders — and the viability of unrelated product bundles disappeared.

Given these conditions, your responses should be targeted, systematic, and dispassionate:
1. Conduct an objective assessment of your portfolio by revisiting its underlying rationale. Examine closely whether you are benefiting from product integration, production scale, and portfolio breadth. Eliminate products that are found to depress company performance.

2. Identify missing elements that would logically improve your portfolio without detracting from scale and productivity. A supplier of ingredients for base lubricants might consider acquiring additional products or technologies that would allow it to expand into new additive areas that are produced with the same manufacturing processes as the original product and distributed via the same channel.

3. Develop an M&A playbook that outlines multiple potential outcomes for your company in terms of markets, products, customer base, and financial performance and the associated pathways to reach them. This includes a logical and efficient manufacturing plan for your product lines, target acquisitions, desirable sequence of acquisitions, contingencies, and options. This playbook will allow you to act quickly when M&A opportunities arise that are suitable for your company’s goals and portfolio and also let you be proactive in taking other approaches to market that are not linked to mergers and acquisitions.
Chemicals CEOs say that their company’s prospects are facing more headwinds now than in 2013…

To what extent do you agree or disagree that “there are more threats to the growth of my company today than there were 3 years ago?”


And they worry about the effect on their industry of significant changes in their markets, technology, and resources…

What are the top three global trends that you believe will be most likely to transform wider stakeholder expectations of businesses within your sector over the next five years?

This is leading many executives to consider pulling in the reins rather than to undertake strategic expansion.

Which, if any, of the following restructuring activities do you plan to initiate in the coming 12 months?

- Implement a cost-reduction initiative: 71%
- Enter into a new strategic alliance or joint venture: 42%
- Complete a cross-border M&A: 31%

Next-generation productivity

Over the past decade, leading chemicals companies have derived significant economic benefits from excellence initiatives segregated into individual corporate functions. Now, however, these initiatives have generally reached the point of diminishing returns, and have even become counterproductive as companies chase growth in a low-growth environment.

The reason for this reversal is that isolated optimization efforts often succeed at the individual functional level but inadvertently hinder cross-functional corporate performance. The result: Companies’ ability to tap into and make the most of growth opportunities is impaired, as is their ability to allocate capital efficiently.

Here’s how this phenomenon played out at an engineering polymers company. It began innocently enough when corporate executives mandated a substantial increase in orders from emerging markets. The company’s sales team fanned out to these new regions, not realizing that customers there were different from the firm’s “traditional” accounts. In general, these new customers wanted to place more products in a single order but purchase a small amount of each item and also request some customization. To secure the business, sales staff promised that the company could meet these requirements, but they hadn’t checked first with manufacturing and supply chain operations.

That’s when things got dicey. The supply chain team, having gone through an extensive optimization program, refused to carry higher levels of inventory; the unit complained that small amounts of many different products would only add to the complexity of managing the logistics channels. This meant that manufacturing had to disrupt its carefully designed lean production system to make this large group of products on a just-in-time schedule.

This battle between conflicting functional priorities at the company led to seesawing performance — some orders went unfilled, others were filled but unprofitable — and before long the customer had departed for a more nimble competitor.
Your company can address this misalignment between functional improvement efforts and corporate strategic priorities through what we call next-generation productivity. The cornerstone of this approach is to adopt an end-to-end perspective of the business, from customer needs through company capabilities. To fully appreciate the possibilities in this approach, take these steps:

- Conduct an impartial assessment of the true growth potential in the markets that you currently control or hope to gain a foothold in. This should be an honest analysis, not the wishful, rosy forecast that you would like to be able to make to investors.

- Ask the company’s functional units to describe how they can meet these growth goals and to provide objective cost and complexity assessments for every action that they recommend.

- Explore the trade-offs and conflicts in the recommendations from each functional unit through the lens of organization-wide productivity gains and revenue and sales growth. Adopt a two-tiered approach to this assessment: *must have* for elements that are needed in order to stay ahead of the competition, and *discretionary* for possibilities that are desirable, even intriguing, but not totally necessary to meet the organization’s immediate goals.

- For must-have activities, strive for functional excellence across the organization, smoothing out activities that would introduce inefficiency or waste in interwoven or neighboring functional units. Simultaneously determine how you can undertake promising discretionary programs and product launches, differentiating the organization without too greatly compromising its excellence benchmarks.

- Reinvest savings from organizational productivity improvements into upgrading discretionary and differentiation activities in the marketplace.

Engineering plastics, crop chemicals, and specialty fibers companies that have adopted next-generation productivity have enjoyed significant reductions in expenses. These can range up to 20 percent in sales and administrative expenses, 15 percent in manufacturing and supply chain costs, and 25 to 30 percent in working capital outlays.
Digital transformation

It has been a long time since the blockbuster breakthroughs, particularly in plastics, that characterized the late 20th century. Since then, chemicals companies have had to make do with incremental technological advances. As a result, it is critical that you embrace digital transformation wholeheartedly, because leveraging new technologies in ways that bring your company closer to its customers is going to be a significant source of value for the industry in the coming years. Offerings based on digital innovation will finally allow you to achieve a goal many chemicals companies have been desperately targeting for decades: becoming a true solutions provider and partner to customers instead of a mere supplier or vendor.

Chemicals companies that are early adopters are already making waves with digital strategies. For example:

• A supplier of process chemicals has installed sensors in dispensing equipment that allow its technical services people to optimize consumption at the customer’s site. These sensors are also providing access to a host of other process data for analysis, which is yielding valuable ideas for optimizing the company’s customer’s operations.

• A supplier of vibration monitoring and other measurement devices has connected its equipment to the cloud and is offering advanced diagnostic services to chemical plant operators.

• A leading polyolefin producer is developing tailored grades suitable for 3D printing. This will permit it to serve a rapidly growing segment of the fabrication industry.

The current zero-growth environment, complete with shifting market dynamics, creates a challenging environment for chemicals companies, but one with significant potential if it is managed well. Ironically, perhaps the smartest course you could take is to adopt an activist mentality yourself, rather than bristling against the ideas proposed by maverick shareholders. In other words, by focusing on improving productivity, organizational efficiency, and digital capabilities, your company may in fact make allies of investors and survive intact while disarray claims the competition.