

May 2020

# COVID-19's Impact on Indian Chemical Sector



## COVID-19's impact on Indian chemical sector

In the weeks following India's lockdown to contain the spread of novel coronavirus (COVID-19), the chemicals sector has witnessed a considerable short-term volatility but is well positioned to benefit in the near future, given the decline in prices of key feedstocks, and COVID-19 related manufacturing shifts away from China. We have examined both the short-term and long-term factors shaping this sector in India, and where future opportunity may lie for corporates, private equity and private owners of business.

The BDA Chemicals sector team would like to share our latest findings with you.

### Executive Summary:

- India's chemicals sector is the 6<sup>th</sup> largest in the world and has witnessed strong growth momentum over the last couple of years. Following global supply-chain disruptions and the government's lockdown measures to restrict the spread of COVID-19, Indian capital markets experienced a significant decline in March 2020, and a subsequent rebound in April. Given the essential nature of the chemical sector, manufacturing operations resumed shortly after the initial lockdown, reflected by a moderate price impact for listed Indian chemical companies
- Even before COVID-19, global chemical manufacturing operations had already increasingly relocated to India from China, which will only continue after COVID-19 as more companies evaluate alternative supply chain solutions. Decline in crude oil prices since the beginning of this year will also have a significant impact on the raw material pricing from a short-term to medium-term perspective
- The short-term impact related to COVID-19 will disrupt the current year financial performance of companies until virus-related economic disruption is mitigated. However, companies with strong balance sheets and low debt levels will be well-equipped to operate through the uncertainty, likely emerging stronger and more resilient operations
- For unorganized players, the inability to adhere to strict social distancing guidelines for resuming operations have led to loss in business to large organized players
- Sectors like Specialty Chemicals, Agrochemicals and Pharma Intermediates will have limited impact given their essential nature
- Insights informed by BDA's longstanding experience in the Chemicals sector highlights how M&A activity will evolve for corporates, PEs and private owners of chemicals business. We would see consolidation, new investments, and distress sale raise the level of M&A activity for corporates and private equity

Overall, we continue to see M&A activity such as growth capital and distress sales to continue in the short-term while consolidation will resume once the impact of the virus can be translated to the financials and future of the businesses.

# Chemical sector in India continues to be resilient during COVID-19 lockdown

Short-term impact during the lockdown given the essential nature of most of the sub-sectors

## Chemical sector in India: Key figures

**US\$163bn**

Size of the India Chemical sector

**6<sup>th</sup>**

Largest in the World

**3<sup>rd</sup>**

Largest among Asian peers

**5.9%**

Contribution to Economic GDP of India

**3.5%**

Contribution to Global Chemical Industry

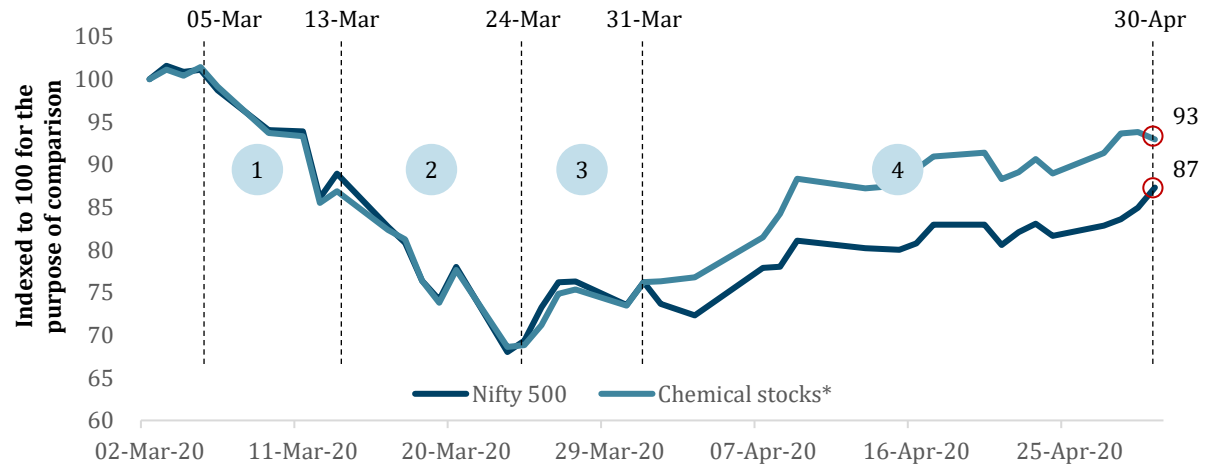
**80,000**

Commercial products across sub-sectors

**12%**

Exports share of Chemical products

## Outperformance of Chemical Companies vis-a-vis Nifty 500 Index



### 1. Impact of global spread of COVID-19

- 14% correction in chemical stocks due to export / import orientation of the sector

### 2. Partial lockdown in India across states followed by nationwide lockdown on 24 March

- 20% correction in the index and sector

### 3. Immediate initial recovery of market

- Short term market recovery post downfall since the beginning of March

### 4. Recovery during lockdown and extension of lockdown on 14 April

- Significant recovery in chemical stocks by 22% as compared to 15% in index

Recent public market trends indicate that the chemical sector in India is fundamentally strong and would remain attractive even in short / medium-term despite the ongoing COVID-19 pandemic

# Potential drivers that will benefit the chemical sector in India


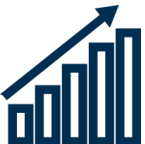


Chemical sector in India to gain favourably over long term resulting in sustainable growth

Drivers	Rationale	Comments																
<p><b>Low crude oil price due to decline in global demand and abundant supply build-up</b></p> <p>Positive impact to the chemical sector in short-term</p>	<p><b>OPEC+ Deal</b> on 12-Apr to cut a record 9.7m barrels/day of production for May and June but further price cuts announced by Saudi Arabia on 13-Apr</p> <p><b>61.9% decline</b> between 02-Jan and 30-Apr</p> <p>66.25 (02-Jan-20) to 25.27 (30-Apr-20)</p>	<p>Typically, 50% oil price drop results in 10%-50% reduction in raw material cost for a chemical company depending on its place in the chemicals value chain. Two key effects of the oil price shocks are:</p> <ul style="list-style-type: none"> <li><b>Cost structure</b> <ul style="list-style-type: none"> <li>Various key chemical building blocks (such as aromatics, ethylene and propylene) for the industry's products are directly produced from oil or its derivatives</li> </ul> </li> <li><b>Price-setting mechanisms</b> <ul style="list-style-type: none"> <li>Oil price shocks affect pricing of commodity chemical and this impacts specialty chemical producers downstream</li> </ul> </li> </ul>																
<p><b>Supply chain shifts from China triggered by environmental issues in 2019 to continue and intensify as global manufacturer act on de-risking input strategy</b></p> <p>Positive impact to the chemical sector in medium / long-term</p>	<p><b>Over 50%</b> <i>Companies experienced sudden, unexpected delays in receiving raw material supplies from China</i></p> <p><b>US\$400m</b> <i>Financial investment by Govt. of India to promote domestic manufacturing of critical Key Starting Materials / Intermediates / APIs</i></p> <ul style="list-style-type: none"> <li><b>Chemical among the top 3 sectors</b> apart from, Metal products and Electronics for sectors with highest <b>reshoring activity from China</b></li> <li><b>India emerging as destination of choice</b> for companies moving out of China due to trade protectionist measures and rising risks because of COVID-19</li> </ul>	<p><b>India has attractive labor cost structure</b></p> <ul style="list-style-type: none"> <li>Over 2005-2015, the average labor cost in China increased ~20% CAGR, against ~5% CAGR in India</li> </ul> <p><b>Plant closures in China an opportunity for India</b></p> <ul style="list-style-type: none"> <li>Shutdown* of 130+ plants across 50 clusters to reduce China's revenue share in global specialty chemical</li> </ul> <table border="1"> <thead> <tr> <th>Top segments - Specialty chemical global exports</th> <th>Specialty Chemical global exports 2018, US\$bn</th> <th>China % share</th> <th>India % share</th> </tr> </thead> <tbody> <tr> <td>API Intermediates</td> <td>77</td> <td>11%</td> <td>4%</td> </tr> <tr> <td>Agrochemicals</td> <td>72</td> <td>17%</td> <td>6%</td> </tr> <tr> <td>Dyes and Pigments</td> <td>66</td> <td>12%</td> <td>5%</td> </tr> </tbody> </table>	Top segments - Specialty chemical global exports	Specialty Chemical global exports 2018, US\$bn	China % share	India % share	API Intermediates	77	11%	4%	Agrochemicals	72	17%	6%	Dyes and Pigments	66	12%	5%
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Source: Investing.com, Press Information Bureau - Government of India, industry reports, news articles, Note: \*Permanent shutdown or relocation due to tight environment standards



## Short-term factors that will impact the sector

*Long-term benefits will outweigh the short-term impacts over the next few months*

	Observations	Comments
	<b>Operational challenges relating to restoration of workforce and adherence to Govt. guidelines</b>	<ul style="list-style-type: none"> <li>• Shut down for essential items was lifted within 2 days but majority of labor migrated to native place resulting in labor shortage and low plant utilization levels</li> <li>• Govt. regulations on strict compliance with social distancing norms to result in low output in the range of 20%-50% across manufacturing units</li> <li>• For unorganized players, the inability to adhere to strict social distancing guidelines for resuming operations have led to loss in business to large organized players</li> </ul>
	<b>Limited impact on demand</b>	<ul style="list-style-type: none"> <li>• Demand orders healthy and robust for Indian chemical exporters with no cancellations of orders witnessed so far</li> <li>• Companies catering to European / US innovator plants for pharma and agrochemicals continue to operate given the essential nature of products</li> </ul>
	<b>Low debt-to-equity ratio for large publicly listed companies across industry</b>	<ul style="list-style-type: none"> <li>• Large publicly listed companies in the chemical sector have low debt-to-equity ratio (&lt; 0.4x) compared to peers in other industries</li> <li>• Companies with strong balance sheet can further leverage (due to low interest rates) and will be able to deploy capex for FY22 / FY23</li> </ul>
	<b>Impact on financials</b>	<ul style="list-style-type: none"> <li>• Short-term impact on profitability due to decline in revenue and operating leverage</li> <li>• Companies likely to witness long working capital cycles resulting in low ROCE for next few quarters</li> </ul>



## Impact on sub-sectors and deal activity (1/3)

*Disruption in chemicals sector globally to drive more opportunities to India*

Sub-sectors	Comments	M&A outlook
 <p><b>Specialty Chemicals</b></p>	<ul style="list-style-type: none"> <li>Indian Specialty Chemical exports have registered a CAGR of 19% since 2015</li> <li>Europe and the US make up 20%–50% of revenue for various companies and an extended lockdown in these regions may have an adverse impact on demand</li> <li>Disproportionate dependency of MNCs on Chinese supplies has already resulted in multiple discussions of shifting of manufacturing to India</li> <li>Suppliers to hygiene and personal care companies will gain in current scenario with products related to essential commodities being relatively protected in terms of demand continuity</li> </ul>	<ul style="list-style-type: none"> <li>Low manufacturing costs, and a recovery in demand from fast growing emerging markets make India attractive from a M&amp;A destination perspective</li> <li>Indian companies would be expected to grow their global market share in specialty chemical supply</li> <li><i>Select Transactions:</i> <ul style="list-style-type: none"> <li>Belgium based Solvay invested in India based Catasynth Specialty to help reinforce its downstream integration into key raw materials</li> <li>Israel based Frutarom’s acquisition of Sonarome enables it to improve its market reach in emerging high-growth markets such as India</li> </ul> </li> </ul>
 <p><b>Agrochemicals</b></p>	<ul style="list-style-type: none"> <li>Relatively immune from the fall in demand due to their non-discretionary nature</li> <li>China accounts for over 50% of total agrochemical imports of India</li> <li>Most of the imports involve intermediates and not the final product</li> <li>The situation is still evolving with capacity utilization in Chinese factories as Indian manufacturers have begun sourcing from other locations</li> </ul>	<ul style="list-style-type: none"> <li>Technicals and intermediates will be attractive M&amp;A themes as agrochemical companies look to diversify their supply chains</li> <li><i>Select Transactions:</i> <ul style="list-style-type: none"> <li>Acquisition of Chinese agrochemical company Yoloo Biotechnology Co. by India based UPL allowed it to expand its technology offerings, distribution networks and product registrations</li> <li>Godrej Agrovet’s acquisition of India based Astec Lifesciences helped it expand into fungicides and grow its backward integration capabilities</li> </ul> </li> </ul>


## Impact on sub-sectors and deal activity (2/3)

*Disruption in chemicals sector globally to drive more opportunities to India*

Sub-sectors	Comments	M&A outlook
 <p><b>Paints, Dyes and Pigments</b></p>	<ul style="list-style-type: none"> <li>• Demand for dyes from COVID-19 hit countries, is likely to remain subdued</li> <li>• Indian companies manufacture large part of chemical intermediates in domestic market but are still dependent on China for some specific dye intermediates</li> <li>• Short-term impact on input cost for dye manufacturing due to import dependency on China. Domestic integrated dye manufacturing players would be in a better position to meet this challenge</li> <li>• Paint companies will benefit from lower prices of crude but are likely to see subdued demand in 2020</li> </ul>	<ul style="list-style-type: none"> <li>• Global majors in the dyes and pigments may look at making investments to diversify their supply chains, making Indian companies potential M&amp;A targets</li> <li>• <i>Select Transactions:</i> <ul style="list-style-type: none"> <li>– Berger Paints acquisition of Saboo Coatings will help it enter new customer segments in a fast-growing Indian market</li> <li>– DyStar’s acquisition of the American chemical businesses from Emerald Performance Materials was carried out with the objective of expanding its product portfolio and driving procurement synergies</li> </ul> </li> </ul>
 <p><b>Chemical and Pharma APIs</b></p>	<ul style="list-style-type: none"> <li>• Indian bulk drug and formulations companies are heavily dependent on import of Key Starting Material (KSM) and Active Pharmaceutical Ingredient (API) particularly from China</li> <li>• China has resumed manufacturing, but it is still operating at lower capacities which may affect raw material prices</li> <li>• Indian API and chemical intermediate manufacturers are expected to be positively impacted in the long-term as customers are pursuing alternate sources for their raw material requirements</li> <li>• Developing import substitutes will be crucial as customers become less price sensitive when it comes to diversifying their supply chain</li> </ul>	<ul style="list-style-type: none"> <li>• Financial sponsors could look at supporting Indian manufacturers as they would need capital over the next few years in building capacity, infrastructure and exploiting the benefits of increased scale</li> <li>• <i>Select Transactions:</i> <ul style="list-style-type: none"> <li>– Morgan Stanley’s investment in ZCL Chemicals, an India based producer of drug intermediates and APIs, would allow it to fast track its expansion plans</li> <li>– Quadria Capital’s invested in India based API manufacturer Concord Biotech. The capital would support the company in its next phase of growth by extending therapy expertise and introducing new range of products</li> </ul> </li> </ul>

## Impact on sub-sectors and deal activity (3/3)






*Disruption in chemicals sector globally to drive more opportunities to India*

Sub-sectors	Comments	M&A outlook
 <p><b>Diversified Chemicals</b></p>	<ul style="list-style-type: none"><li>• Demand from user industries such as auto, consumer durables, energy, electronics, polymers, and fuel additives may slow down</li><li>• Weak crude oil prices will favor Indian industries who are a net importer of crude and derivatives</li><li>• Considering the critical role played by chemical industry in the essential goods value chain the industry will gradually scale up operations</li><li>• The COVID-19 outbreak in China has highlighted the risk of overdependence on single country for supply chain</li></ul>	<ul style="list-style-type: none"><li>• China has been one of the key manufacturing destinations for some of the large global chemical companies who could look to geographically diversify their sourcing plans to countries such as India</li><li>• <i>Select Transactions:</i><ul style="list-style-type: none"><li>– US based Celanese Corporation acquired India based Next Polymers to support its global manufacturing base and supporting customers in a high growth region</li><li>– Netherlands based DSM's acquisition of India based SRF's engineering plastic business allows it to further grow its Indian business without having to incur significant capacity investment</li></ul></li></ul>



## Our view on M&A and PE investments in this sector

*Insights from BDA's experience in this sector and recent conversations*

	Insights	Comments
	<p><i>Short-term M&amp;A outlook</i></p> <p><b>Maintain the status quo</b></p>	<ul style="list-style-type: none"> <li>• Transactions in progress that are good value buys, essential commodities / backward integration will continue</li> <li>• Distress sale to pick up as large players with healthy balance sheet will look at this as an opportunity to consolidate</li> </ul>
	<p><i>Long-term M&amp;A outlook</i></p> <p><b>New sellers in the mid-market</b></p>	<ul style="list-style-type: none"> <li>• M&amp;A of equals and profitable companies at good valuations are likely to get consummated going forward</li> <li>• Bolt-on acquisitions to pick up momentum as private companies will look to exit businesses due to high pressure of competition</li> </ul>
	<p><i>Private Equity</i></p> <p><b>Investments from sector agnostic funds</b></p>	<ul style="list-style-type: none"> <li>• Sector to generate interest from a wider group of PE investors other than only Chemical focused PE funds</li> <li>• Sector continues to be resilient with fair valuations. PE funds to identify right opportunity to maximize returns</li> </ul>
	<p><i>Private Equity</i></p> <p><b>Focus on investments in good mid-size assets that may see uncertainty</b></p>	<ul style="list-style-type: none"> <li>• Private Equity to rescue some good businesses where mismatch in valuations can be corrected</li> <li>• Pipeline deals to see closures although valuations could have an impact</li> </ul>
	<p><i>Dominant industry players</i></p> <p><b>Global MNCs to look at divestments</b></p>	<ul style="list-style-type: none"> <li>• Global operations to have minimum impact on profitability as lockdown impact across geographies is over different periods</li> <li>• Companies likely to evaluate assets and divest non-core and underperforming businesses in order to improve profitability</li> </ul>

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## BDA's global coverage

