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Finding M&A Opportunity In China Chemical Distribution

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Juma Capital presents an on-the-ground view of China’s chemical distribution industry, and analyzes the local ingredients to acquire and build distribution platform companies in China.

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In this paper, Juma Capital presents an on-the-ground view of China's chemical distribution industry to international strategic investors who aspire to build China distribution networks. The analyses and views are from the ongoing industry research of Juma Capital team. The interviews with local owners and industry executives lend additional acquisition insights into a massively changing industry.

Introduction

The blockbuster USD 2bn merger of Univar and Nexeo Solutions completed earlier this year highlights the industry consolidation trend prevalent in the chemical distribution sector, outside of China. During the last two decades, consolidation in the chemical distribution industry in Europe and the United States have accelerated, with heavy involvements of private equity buyout funds; today top distributors command over 40% market share in the United States and over 20% in Europe.

Inside China the industry picture is quite different. The distribution industry is fragmented; and very little consolidation is taking place. International chemical distribution companies have been trying to execute a similar buy-and-build acquisition strategy to build up China distribution platforms. To date however, there have been only a few notable cross-border bolt-on transactions, and a handful local acquisition deals, inside the world's largest and fastest growing chemical distribution market.

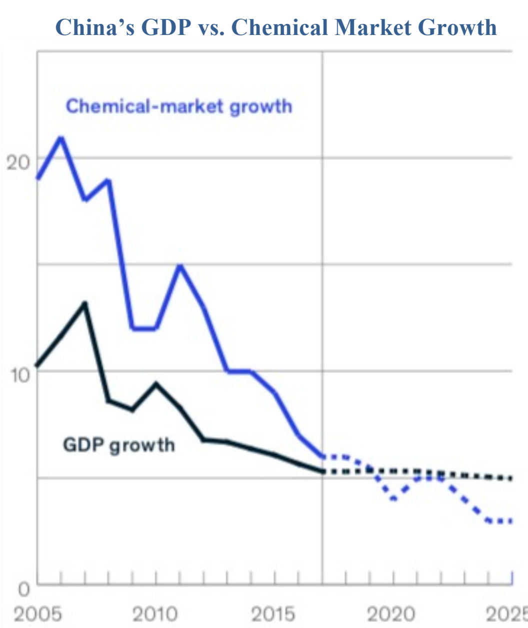
Juma Captial believes that the consolidation trend in Europe and the United States in the past decades reflects the future of the distribution industry in China. A number of factors indicate that the chemical distribution industry in China is growing more matured for consolidation.

Industry at a Glance

China's chemical industry has been growing in tandem with its economy. In 2018 China's GDP reached RMB 90tn from RMB 10tn in 2001 (National Bureau of Statistics). During the same time China's chemical industry revenue has grown rapidly, becoming the largest in the world since 2011.

China's chemical industry represents 10% of its economy: chemical sales reached RMB 8.71tn in 2017 (National Bureau of Statistics); that is approximately 40% of the global chemical-industry revenue (Mckinsey & Company China Chemicals Practice, Sheng and et al., March 2019). At a moderate growth rate of 6% in line with China's estimated GDP growth, China is expected to contribute over 50% of the global chemical industry's growth in the coming decade.

China's GDP vs. Chemical Market Growth



Data Source: Mckinsey & Company China Chemicals Practice, 2019

According to Boston Consulting Group's research, China's third-party chemical distribution market was EUR 35bn in 2012, comparing with North America market of EUR 29.9bn, and European market of EUR 42.9bn. Going forward, growth of world chemical distribution industry will be led by China. BCG estimates that China's chemical distribution market will grow at 9% CAGR from 2017 to 2022, comparing with 4% CAGR of North America market during the same period.

Growth Dynamics

China's third-party chemical distribution is growing faster than the overall chemical industry, as producers rely more on distributors to expand coverage for more regions of rising affluence. Better distribution services are a large part of China's continuing urbanization underpinning the economy.

The race to grow distribution in a colossal country cannot be understated: in the United States, ten cities have over one million population, while approximately five hundred Chinese cities have over one million people, and one hundred mega cities with population over five million (China National Census). Further reach and better service coverage are key driving forces behind the growth of Chinese distributors.

A Short Industry History

The Chinese distributors have a relatively short corporate history, dating back to the evolution of chemical import policies shaped by the reform and liberalization of China's economy. Before 1990s, chemical imports in China were controlled and dominated by government-run entities. Between 1982 and 1993, the Ministry of Foreign Economic Relations and Trade was formed and restructured to better regulate import and export activities; the China Chemical Industry Import and Export Company (CCIIEC) was part of this ministry, responsible for all essential chemical imports into China, such as petroleum, chemicals, fertilizers, and rubber. The majority of other chemical products were imported by approximately two hundred designated regional and provincial CCIIECs.

In the 1990s, many private companies were formed and obtained import licenses for foreign chemical products as the liberalization policies allowed for new importers to enter the sector; a number of regional CCIIECs were privatized as the distribution sector became reformed and less regulated. Majority of China's first-generation private distributors traced their origin during this boom in the 1990s when their companies were established.

China Chemical Distributors

Thirty years after the flourishing of the private sector, China's immense chemical distribution industry is predominated by hundreds of thousands of private-owned local distributors. To say that China's chemical distribution industry is fragmented is an understatement: local industry research entities are still trying to agree on the right order of the number of local distributors, since little information is publicly available on these private companies.

The ICIS Top 100 Chemical Distributor List for Asia includes only one Chinese distributor, the state-owned Sinochem Plastics. Many more large Chinese distributors did not make the ICIS list because these companies do not disclose financial information publicly.

One industry leader, the Chairman of Hersbit Chemical (NCM), a well-known distributor since 1992, estimates that there are 500,000 small and regional Chinese distributors, serving international producers, and 24,869 Chinese producers with scale (2017 National Bureau of Statistics). Another industry insider from Brenntag China estimates that there could be a few thousand Chinese distributors with meaningful operating scale: similar to the total number of distributors in North America and Europe.

Majority of the Chinese distributors are private-owned enterprises (POEs), with a small number of state-owned enterprises (SOEs), and multinational companies (MNCs). There are also dozens of e-commerce B2B platform companies with growing on-line trade volume.

Private-owned companies

POEs have largely grown organically since the 1990s when China's chemical imports and exports was deregulated and SOEs privatized. POE distributors are typically majority-owned and operated by the first-generation entrepreneurs, with limited financial resources. These private companies however, are entrepreneurial, nimble, and still have a growth mindset. POE businesses are driven by the long history of relationships with manufacturers,

and regional customers. Majority of the distributors provides simple services such as storage and transportation, and trade credits to their customers. A small number of POEs are upgrading their services to include additional value-adds. Representative POE distributors include Shanghai Hersbit Chemical, Nanjing Gutian Chemical, etc. In the private sector there is barely any service brand well recognized nationwide by the industry in China.

State-owned companies

SOE distributors are typically large companies, often subsidiaries of larger SOE groups. These companies' history dates back to the early days of China's opening its door for importing chemicals into China, and getting early import license grants. Most SOEs have easy access to bank capitals, allowing them to offer better credit facilities to their customers. SinoChem Plastic, a wholly owned subsidiary of SinoChem International, is the largest chemical distributor in China.

Multinational companies

In 2004, China changed its regulations to allow for one hundred percent foreign ownership in the chemical distribution sector. Today most of the well-known MNCs are operating in China, such as Brenntag, Univar Solutions, IMCD, and Azelis, etc. Over the last decade, the MNCs have been investing in China to increasingly develop their businesses, partnerships, and acquire companies to accelerate growth. Brenntag, for instance, has acquired Chinese distributors to build out its national presence in China.

E-commerce Platform companies

Chemical e-commerce platforms are growing quickly in the last ten years, albeit accounting for less than 3% of China's chemical distribution market (Zheshang Securities research). The B2B companies target small and long-tail customers, offering tens of thousands of products. These internet-based services address a number of key pain points in the business: small buyers need transparency on product prices, and sellers need direct contact to clients. Chemical B2B companies are increasingly built to provide more value-added services in logistics, financing, and technical know-how.

According to the research of 2B.cn, there are 56 chemical B2B platforms in China by 2016; about 20 companies secured financing of approximately RMB 1.27bn. Launched in 2013, Molbase is the largest chemical e-commerce platform in China, with monthly GMV over USD 1bn, serving 30,000 suppliers and 124,000 registered customers in 150 counties.

Recent Policy Impact

Stiff regulatory enforcement for environmental and safety compliance is the most important factor affecting China's chemical industry in the recent years. The US-China trade war and the rising tariffs are causing pressure to distributors focused on US China businesses.

Tightening Regulations

In 2015 the Tianjin '8.12' explosion caused by unregulated hazardous chemicals was a watershed national event: the explosion caused 165 deaths, 798 injuries, and damages to 304 buildings, 12,428 transport vehicles, and 7,533 containers. Since the Tianjin explosion, regulatory requirements became much more stringent for safety in chemical production, storage, transportation, and environmental compliance. The ensuing four waves of nationwide environmental and safety inspection in 2016 have resulted in closure, and facilities improvement of some 73,290 companies.

China's Regulatory Enforcement
(Plants closed, fined)

	Provinces / cities covered	Date	Number of enterprises required to rectify or shut down	Number of cases filed and companies penalized	Fine charged (mn RMB)
Trial	Hebei		200	125	-
First wave	Inner Mongolia, Heilongjiang, Jiangsu, Jiangxi, Henan, Guangxi, Yunnan, Ningxia	July 16, 2016	9,617	2,659	198
Second wave	Beijing, Shanghai, Hubei, Guangdong, Chongqing, Shaanxi, Gansu	Nov 24, 2016	10,512	5,779	243
Third wave	Tianjin, Shanxi, Liaoning, Anhui, Fujian, Hunan, Guizhou	July 29 - Aug 1, 2017	20,359	7,086	335
Fourth wave	Jilin, Zhejiang, Shandong, Hainan, Sichuan, Tibet, Qinghai, Xinjiang	Sep 15, 2017	32,602	9,181	466
Total			**73,290**	**24,830**	**1,242**

Data Source: Zheshang Securities research (浙商证券研究), JCL research

Forced Consolidation

Stringent compliance requirements are driving chemical industry consolidation from upstream producers to downstream distributors and logistics service providers: all are expected to respond to the government's new environmental and safety mandates.

In Jiangsu province (population of 80 million in 2018) alone, one of the wealthiest provinces with over 5,000 chemical production factories in 2016, the government is enforcing the reduction of chemical production facilities in great quantity and repositioning chemical industry parks. In the chemical distribution industry, many small chemical distributors without proper licenses for storing and transporting chemicals are facing closure, or merger by large properly licensed companies.

Central and provincial governments are also mandating chemical companies to move their businesses into regional chemical industrial parks, in an effort to centrally regulate, improve and enforce industry standards. 502 central and provincial chemical industrial parks are now designated to house international and local chemical companies, accounting for approximately 51% of total national chemical producers. MNCs such as Brenntag China are building facilities and securing their foothold in these regional parks as well.

US-China Trade War

The Sino-US trade war has placed pressure on the chemical distribution industry, especially on US chemical companies exporting to China, and Chinese chemical companies distributing to the US. However, short-term negative impact of higher duties resulting in lower trade volume was not as significant as expected. In 2018, trade volume for certain chemicals actually increased between US and China as traders stock piled in anticipation of increased prices.

In the instance of American chemical producers who are competing to retain market share, China market is so important that manufacturers cannot risk price increases to Chinese customers, and losing businesses to competitors. Few customers, on the other hand, would accept increases in prices. In the short run, many chemical producers would lower their prices and absorb the increases in tariffs to keep their customers happy, and competitors away.

In the long run, if the increased tariffs persist, chemical producers would consider moving their plants outside of the US, or China so they can supply without the tariff to compete squarely against other global companies. It is known in China that many global IT companies are already drawing up plans to move their factories outside of China to avoid higher tariffs.

Financing Shortage

Chemical distributors in China have been facing general lack of industry financing. The bank lending policies towards POEs are not favorable; there is a shortage of alternative financing sources, such as growth capital, or private equity that drive consolidation in the industry.

Bank Financing

China central bank's current policy to deleverage and de-risk the balance sheets of

large businesses and municipal governments reduces the capital liquidity available in the industry. For the upstream chemical producers where there is need to upgrade infrastructure to comply with the new environmental and safety regulations, capital expenditure has slowed down due to deleveraging, and liquidity issues.

Data Source: China National Statistics Bureau; JCL research

Working capital financing enabling the growth of the distribution business has also been inadequate. Chinese banks can quite easily lend to SOEs with government asset pledges, while few banks would lend to smaller and private businesses. Seventy percent of the POEs obtained financing in 2018 from private lending for amounts below RMB 1mn (China Internet Private Borrowing Research); such financings are too small for distributors to grow to scale. For POE distributors that have lean balance sheets and few assets to pledge, bank financing is very difficult to come by.

Local PE/VC Funds

While the Chinese PE/VC firms have been actively funding chemical B2B platforms, they have yet to show interest in investment into the traditional chemical distribution business. Chinese private equity and buyout firms have not partnered with the first-generation Chinese entrepreneurs to grow by consolidating competitors. The PE backed successes like Brenntag or Univar has not been seen on the capital markets in China.

International Buyout and PE Funds

In Europe and North America, PE funds are an important driving force in the growth and consolidation of chemical distribution companies. The international private equity firms that are experienced in buy-and-build deals are yet to play in China. The likes of Bain Capital, CVC, TPG and Apax, who are behind the formation of Brenntag, Univar, IMCD, and Azelis have not invested in any Chinese 'platform' company.

On the one hand, most of the Chinese distributors are too small to suite the appetite of the large international funds that are used to buy-out deals with EBITDA numbers north of USD 50mn to USD 100mn; only a small number of local distributors in Juma Capital research are generating and sustaining these levels of cash flow. On the other hand, the few larger distributors who are generating good cash flows have aspiration to attract local pre-IPO funding for domestic IPO listings, to be the future consolidators.

Opportunities for China M&A

Despite the lack of financial acquisitions by PE funds, the roll-up acquisitions in China by local listed companies and international distributors are taking place. Companies with strategic vision and access to capital are building China chemical distribution platform companies.

Timing is right to engage and discuss partnership and exit strategies with the first-generation business owners. A large number of the Chinese distributors are running maturing businesses, with stable customer and supplier relationships dating from the 1990's when the industry deregulated and distribution businesses took off.

There are increasing opportunities in the specialty chemical sector for buyers to identify target distributors with meaningful size, and higher distribution margin. Growth in the specialty chemical sector will continue as China's development policy is shifting towards a consumption-led economy. New and more sophisticated products for personal care, home and automobile care, new food ingredients, for instance, are leading to the growth in the specialty sector.

Past China M&A Transactions

Although rationales behind the transactions differ, there are common themes: building better infrastructure facilities, gaining better access to financial and end-market resources, and acquiring distribution platforms for improved national and provincial coverage.

Sinochem International (SH: 600500) 中化国际

Sinochem International is a SOE company listed on the Shanghai Main Board. In December 2017, Sinochem International acquired Sinochem Plastics in a related party transaction, with the stated intention to strengthen Sinochem International's number one position in selling plastics to the automotive industry. The acquisition is for a total consideration of RMB 947mn, based on SinoChem Plastics' 2017 net profit of RMB 126mn.

SinoChem Plastics is ranked no. 6 on ICIS' Global Top 100 chemical distributors list for 2019. Its main business is in engineering and performance plastics, along with plastics additives and industrial chemicals.

Brenntag (GR: BNR) China 布伦泰格

Brenntag has made acquisition a key component to its overall growth strategy. According to its 2018 annual report, the company spends about $236 - $355 million a year towards acquisition. Brenntag's China acquisition strategy is to build and fortify regional facilities in chemical industrial parks in line with the government's mandate. Its Chinese entity intends to build a specialty chemicals business, and plans to be a full-line distributor offering a comprehensive portfolio of products and services.

Over the last ten years, Brenntag is the only multinational distributor that has made significant acquisitions in China. In 2011, Brenntag entered Chinese market through acquiring 51% equity of Zhong Yung (International) Chemical. Zhong Yung is focused on the distribution of solvents with established commercial and logistical infrastructure in the key economic regions in China. Total enterprise value for the 51% equity is EUR 66.7mn. The Zhong Yung Group generated sales of more than EUR 200mn and posted EBITDA of EUR 14mn in 2011, indicating an EV/EBITDA multiple of 9.3X. Brenntag acquired the remaining 49% of Zhong Yung in 2016 for EUR 62mn.

In 2017, Brenntag acquired 51% of specialty chemical distributor Wellstar Enterprises (Hong Kong) with its three Chinese subsidiaries, expanding its market position in China's specialty chemical segment. Wellstar generated sales of EUR 28mn in 2016 and was valued at EUR 25.3mn. Brenntag will acquire the remaining 49% of Wellstar in 2021.

With these acquisitions, Brenntag is establishing its China platform. According to the company's China management, Brenntag China has 450 employees, with annual revenue between RMB 2.5bn to RMB 3bn in 2018.

Zall (HK: 02098) 卓尔

Zall is a Hong Kong listed Chinese company aspiring to create the world's largest B2B transactional platform and database. The company has undertaken a number of acquisitions in building up B2B transactional and service platforms for consumer, agricultural, chemicals, and industrial products.

In March 2018, Zall acquired 52.48% equity of HSH International (化塑汇) for USD 29.5Mn. HSH International operates Huasuhui.com, an online B2B platform for chemicals and plastics, and is one of the largest chemical B2B sites in China.

Milkyway (SH: 603713) 密尔克卫

Milkyway is the only chemical logistics and distribution company, recently listed on Shanghai Stock Exchange in 2018. The majority of Milkyway revenue comes from chemical logistic services, with a small proportion from specialty chemical distribution. The company's EBITDA grew more than 50% in 2018 and is expected to grow by more than 30% annually during 2019-2021. It is traded at RMB 6.0bn market capitalization (May 29, 2019), with a rich 19.2X 2019 EV/EBITDA.

In the past five years, Milkyway has completed fifteen acquisitions, mainly to

build up its chemical transportation and storage capabilities nationwide, with facilities that meet environmental and safety standards.

Univar (NYSE: UNVR) China尤尼威尔

Univar China is operating in seven cities with its headquarter in Shanghai. Univar China has over 50 premier global chemical producers, and over 150 qualified local producers as business partners, focusing on personal care, lubricants & MWF, food ingredients, chemical manufacturing, household & industrial cleaning, and water treatment.

In 2006 Univar acquired the assets of Shanghai Jixing Chemical Co., Ltd., a small distribution company in Shanghai. Jixing specialized in chemicals for the paint and coatings industry, serving manufacturing customers in eastern China. The acquisition of Jixing gave Univar access to over one thousand local customers in the paint and coatings industry.

As part of Univar's acquisition of Nexeo, the non-plastics business of Nexeo China merged with Univar China in 2019 and became part of Univar China. According to ICIS 2019 report, Univar Asia generated USD 393mn in revenue.

IMCD (ENXTAM: IMCD) 艾敏斯帝

IMCD is a world leader in the distribution of specialty chemicals and food ingredients. IMCD's group activity is organized around the markets in household cleaning, pharmaceuticals, personal care, CASE (coating, adhesives, sealants, and elastomers), food nutrition, lubricants, chemical and plastics mixers.

In 2013, IMCD acquired Singapore-based Paceco Industrial Supplies, a reputable distributor for engineering and specialty plastics. Paceco is active in Singapore, China and Malaysia, and represents some of the most highly regarded producers in the region. The acquisition complemented IMCD's plastics business in China and provided a platform for its further expansion in Southeast Asia.

Nexeo Solutions

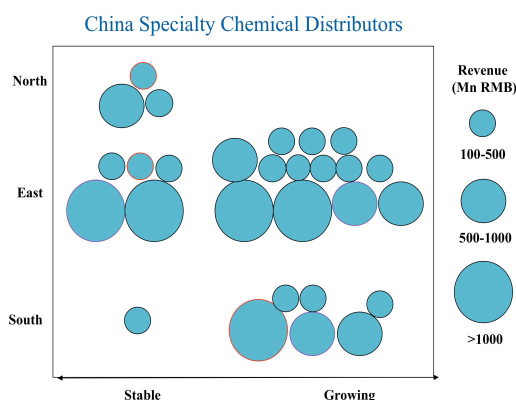
Before its mega merger with Univar, Nexeo formed a joint venture with the shareholders of Beijing PlasChem Trading Co., to establish a new entity in China in 2012. Beijing PlasChem is a professional distributor dealing in engineering plastics, common plastic, chemical material and additive as well as agrochemical. Headquartered in Beijing, the company had subsidiaries and offices in Shanghai, Shenzhen, Yuyao, Chongqing and other cities. The JV entity absorbed the existing supplier and customer relationships, inventory and employees of Beijing PlasChem. The transaction expanded Nexeo's plastics business nationwide in China.

Deal-friendly Distributors

To identify a group of deal-friendly companies, Juma Capital has conducted research covering more than three hundred Chinese chemical distributors. These researched distributors are in specialty chemicals, and are typically medium to small players. Most are growing regionally selling complex international chemicals for food, personal care and home care, pharmaceuticals, CASE, lubricants and various other specialty chemicals.

The distributors' business information is from the local Administration of Industry and Commerce (AIC) records, corporate statements, and company credit reports. Meetings with the owners help validate the most recent AIC records, and lend additional insights on owners' disposition towards a serious M&A dialogue.

Twenty-eight companies are short-listed based on their revenue size, growth history, sector specialties, regional presences, and equity structures; all of these are key factors in M&A considerations.



Data Source: Administration of Industry and Commerce; Juma Capital research

M&A Considerations

Critical business discussions can be managed directly with the owner and the decision-maker of the businesses. About ninety percent of the chemical distributors researched and tracked are POEs; over two thirds of these POEs are controlled by one owner holding over fifty percent of the company's equity share.

Exit discussions are relevant and timely, since more than half of the researched companies have been in business for over twenty years, and are still owned and run by first generation entrepreneurs. Many entrepreneurs are candid about their company and family disposition, and whether their second-generation family members are interested in inheriting the businesses.

Getting funding to grow is appealing for the researched companies as all of the companies are self-funded, and have not completed equity financing. Finding the right partner, financial or strategic, is top-of-the-mind discussion.

Geographical synergy is a critical consideration: Shanghai and Guangzhou are corporate headquarter locations for most of the chemical distributors, local or international. Ninety percent of covered companies are based in East or South China, where these companies provide coverage to customers in Yangtsz River Delta and Pearl River Delta regions accounting for one third of China's economy. MNCs already operating in China will weigh in heavily on geographic preferences for management integration, and distribution coverage.

There is good cultural fit with the MNCs: The distributors tracked in the research speak the same MNC business language, and have been managing relationship with a large number of MNC suppliers. It is typical for one of these distributors to manage and deal with several dozen MNC suppliers from many countries.

Sensible Approach

Local distributors prefer indirect, and quiet 'dating' conversations for funding, and increased products and coverage. Loud conversations by big firms are often the wrong local chemistry.

POEs that have been approached by international bankers and companies are often turned off by the high-handed acquisition proposal quoting international consolidation successes; the approach is viewed as a yes or no international marriage proposal before the dating conversation has yet to take place. Suffice to say there is neither trust nor confidence in the future endeavor together.

Early Due Diligence and Risk Assessment

Early due diligence for investing and M&A transaction is critical, as Chinese private companies don't release operating business information publicly. While asking for company financials at a Chinese banquet will likely be frowned upon, early due diligence should check with local filings, tax records for initial deal assessment. Leveraging local advisors' skillful role in getting the financials, validating the numbers, and facilitating the negotiation with the right quantitative information are essential early on.

Risk factors for each target under consideration should be clearly spelled out. On the balance sheet, quality of account receivables is a very common issue as the end market customers are often small and delinquent. Consistencies of cash flows over the years should be assessed as the upstream and downstream contracts are changing annually. Unpaid tax liabilities,

local or national, is most often another deal killer.

On the people side, the personal history and integrity of founders in the industry should be well checked and verified. It is also critical to find out how suppliers and customers' contracts are tied to long time employees, and whether change of control (COC) of the distributor alters the contractual relationships. The key employees typically have no equity in the company and most don't have profit sharing plans for the business units. So the incentives for key employees to stay need to be understood.

Flexible Deal Structures

Outright acquisitions such as those executed by Brenntag in China often come with an earn-out period and management performance targets. Proper rachet clause is acceptable locally as the sellers often ask for high prices at rich multiples, quoting valuation multiples of comparable companies from China's stock market.

Carve-out deals are often structured to acquire larger local companies, so that the MNCs would only acquire the distribution businesses, leaving aside manufacturing and real estate assets.

International companies quite often make *time-barred minority investments* to help fund the growth of Chinese companies; the approach suites the local growth mindset, and at the same time gives the strategic investor a call option to acquire the company prior to an IPO or an outright sale.

Few will enter a China joint venture given many in the past decades failed to endure for the long run. No two companies could align international and local goals, and both hands-on manage the business at the same time. International acquisitions should ensure sensible local contribution, operation control, and clear alignment of strategic priorities.

Summary

The on-going US-China trade war is pushing China to further open up to global competition, and better integrate itself into the world economy. China's massive chemical distribution industry will not be a black box separated from the global economy, as the Chinese government encourages MNCs to bring in more direct foreign investments for better quality and international standards. At the same time competitive Chinese chemical producers are looking for MNCs to partner and export globally, as China increasingly becomes a net exporter of its own chemical products.

For over a decade China's chemical distribution sector has been deregulated, and opened to foreign ownership. Recently the change to stricter enforcement of regulation has further leveled the playing field for MNCs, who are better suited to compete with innovative products and services, and better international safety and regulatory standards.

For MNCs and Chinese distributors, finding the right M&A opportunities in this environment, could perhaps lead to long and enduring international partnerships.

And greater synergies ever imagined.

Juma Capital

Juma Capital is a boutique advisory firm in China, advising China-centric cross-border M&A, merchant banking and investment transactions, and providing financial modeling and strategic advisory to our clients. Juma Capital also makes principal co-investments, offering financing to growth stage companies.

The professional team is unique with decades of China experiences in securities, financial, accounting, legal, regulatory arena, and handholds clients across linguistic, cultural, business-model, governance and regulatory chasms in bringing closure to tailored deals. Juma Capital works within a network of deal partners who support the transactions professionally, and resolve various local issues.

Within the complex cross-border environment, Juma Capital's mindset is that of a long-term China partner for our clients: international companies, family offices, institutional investors, public companies, and all are challenged to achieve their long-term objectives in China.

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