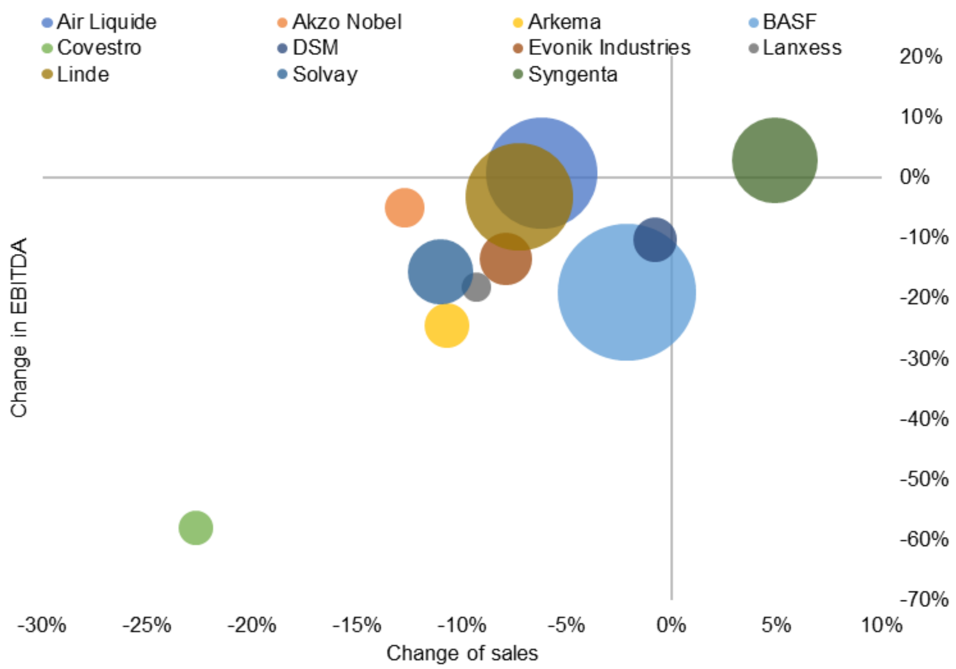
European chemicals outlook: tough H1, bumpy H2 ahead, 2021 uncertain

Covid-19 has had a mixed impact on the chemicals sector so far. Specialty suppliers have fared less badly than bulk suppliers, notably those exposed to car manufacturing, construction and transportation. Credit quality now rides on a continued economic recovery.

With the second-quarter reporting season mostly over, the disruption to industry caused by coronavirus was visible in sharply lower revenue and EBITDA recorded by Europe's chemicals companies. Overall financial results for H1 2020 came in largely in line with our expectations. Companies exposed to the automotive and aviation industry will likely continue to face supply-chain bottlenecks whereas specialty chemicals companies are weathering the crisis comparatively well.

Most companies can cope with the temporary drag on operating cash flow, having strengthened their product portfolios in recent years and bolstered their balance sheets. With regards to overall credit quality, the most important factor is the strength and duration of the economic recovery next year.

Figure 1: European chemicals companies (iBoxx Main): percentage changes in H1 revenue, EBITDA (2020 vs 2019); size of circles indicates size of end-June net debt



Source: Scope, company data

Companies making up Europe's chemicals sector have a wide business mix. But bulk – or integrated – chemicals companies such as BASF SE and Covestro AG faced a double blow: not just the Covid-19 shock but also the collapse of oil prices in March and April.

The pandemic knocked demand for oil-based products lower but the prices of commodity chemicals, which track oil prices, also fell as Brent crude dropped toward USD 20 a barrel, though it has recovered to more than USD 40/barrel in recent weeks. We had captured the significance of the oil market in our updated 2020 outlook: European chemicals sector credit outlook remains stable: balance sheets strong, China recovers (25 March).

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Figure 2: Oil prices versus benchmark market prices for polyolefins, and intermediates

	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020
Brent crude oil (USD per barrel)	64	68	62	63	51	33
Western Europe ethylene (EUR per metric ton)	995	1065	993	973	953	673
Western Europe propylene (EUR per metric ton)	933	983	893	852	838	617
Northwest Europe MTBE (USD per metric ton)	126	295	374	282	165	68

Source: LyondellBasell Industries

In the spotlight: H1 review of Europe's chemicals sector (iBoxx Main)

Bulk chemicals suppliers:

BASF, Covestro

A sharp decline in demand from the automobile and construction industries as the pandemic disrupted supply chains and forced factory closures hit bulk suppliers Covestro and BASF hardest. Covestro derives around 19% of revenue from the automobile and transport sectors, and BASF between 10% and 20% from the transportation sector. Prices for bulk products also fell significantly. At Covestro, volumes in the company's core polyurethanes and polycarbonates units fell by double-digit percentages. BASF said prices in its Materials division fell by 8% yoy. Covestro said Q2 prices at its polyurethane business fell more than 12%. The companies reported sharply lower H1 results despite their important downstream activities (BASF: up to 50%, Covestro: ~20%). BASF has withdrawn earnings guidance for the rest of 2020, suggesting the companies face tough trading conditions at least until Q4 2020.

Specialty chemicals suppliers

Air Liquide, Linde

Industrial gas suppliers showed typical cyclical resilience as providers of essential industrial products and services, usually sold on mid to long-term contracts. Their healthcare arms also benefited from strong demand from hospitals for oxygen. France's Air Liquide SA and Germany-US company Linde PLC have well diversified customer portfolios across industry and by geography. At Air Liquide, the company's Merchant activities – selling packaged gases (high-pressure gas cylinders) through multiple channels – encountered more severe headwinds than its large industries business; less badly affected by lockdowns. Based on the solid performance in H1 2020 coupled with the high visibility of the business, Air Liquide and Linde remain among the most resilient companies in the specialty chemicals industry. We don't expect the relatively high levels of reported net debt of Air Liquide and Linde of around EUR 12.4bn and almost USD 11.3bn respectively to have an adverse effect on their credit profiles.

Akzo Nobel

The Netherlands-based coatings and paints supplier partially limited the impact of a sharp drop in H1 demand with prices rises and cost savings, so EBITDA fell just 4% on a 13% decline in revenue as operating profit margins improved. The company's decorative paints unit offset a 10% drop in demand with a 3% improvement in its price mix – a sign of the company's pricing power – leaving H1 revenue down 10%, but operating income higher. The performance coatings unit – whose customers are mostly in the automotive, marine, aerospace, construction industries – fared less well: revenue fell 14% on a 15% decline in volumes and 2% improvement in the price mix, leaving operating income flat.

Arkema

Like other European specialty chemical companies, Arkema SA's activities delivering intermediate products to car makers and the construction industry experienced a steep decline in demand. This was partially mitigated by demand from the nutrition, packaging and hygiene sectors. The Q2 economic turnaround benefited Bostik, the French company's adhesives division, notably in the construction sector (around 25% of sales), general industry (around 69% of sales) and the consumer DIY segment. Arkema's cash position was strengthen by proceeds of EUR 350m from the of its Functional Polyolefins business to SK Global Chemical (closing 1 June 2020).

DSM

Netherlands-based Koninklijke DSM NV reported relatively robust H1 results. The company is well positioned as a leading supplier of products for human and animal nutrition where solid demand, partly through stock-building by customers, offset a slump in activity at its materials unit, which is exposed to the automotive and construction sectors, among others. The company's nutrition business reported a 5% rise in company-adjusted EBITDA on a 6% rise in revenue in contrast with a 28% fall in EBITDA at the Materials unit on a 16% decline in revenue. Overall H1 adjusted EBITDA fell just 4% on a 1% decline in revenue from the same period in 2019.

Evonik Industries

Evonik Industries AG reported a double-digit decline in H1 EBITDA compared with the same period of last year, but its EBITDA margin slightly increased. This was mainly attributable to the performance of its Specialty Additives and Nutrition & Care divisions. Evonik's pricing power, cost savings, and higher demand at nutrition and care contributed to the improved profitability. The company's recent acquisition of US-based PeroxyChem for about EUR 600m contributed to a rise in net debt at June 30 from a year ago. For the full year, Evonik expects business in the specialty additives division will be influenced by lower demand from the automotive sector but demand for additives for packaging, agrochemicals, and lightweight construction materials will develop well.

Lanxess (BBB+/Stable)

Germany's Lanxess AG reported a 18% fall in H1 EBITDA on a 9% fall in revenue compared with the same period last year. The Covid-19 shock to the automotive industry badly hit the company's Engineering Materials business, where EBITDA fell 41%, though Specialty Additives (down 16%) and advanced intermediates (down 14%) were less badly affected. Lanxess's performance in general suffered from lower demand from major sectors – industrial manufacturing, automotive and transportation – and higher raw material costs. On the positive side, the company's newly formed Consumer Protection unit reported double-digit revenue growth due to considerable demand for disinfectants, among other products. Indebtedness has fallen significantly due to proceeds from the sale of its 40% stake in chemical park operator Currenta (see Lanxess: Disposal of 40% stake in Currenta will further support credit metrics).

Solvay

Belgium-based Solvay SA reported considerably lower H1 EBITDA as relatively robust showings from its business serving the food, agricultural and feed markets were offset by weak demand from the oil and gas, automotive and aerospace sectors. H1 earnings would have been worse were it not for EUR 170m in cost savings. The company expects a tough Q3 and improvement in trading conditions in Q4. However, with around 45% of its business exposed to construction, automotive, civil aerospace, mining, and shale oil and gas, headwinds could persist for longer.

Syngenta

Switzerland's Syngenta AG, as a leading producer of crop-protection products and seeds, benefited from solid agricultural demand in the first half, particularly in North America where poor weather weighed down on results in the H1 2019. That said, in line with competitors including US-based Corteva Inc, sales growth was held back by adverse exchange rates, notably weakness in the Brazilian real. As a pure-play agriculture and farming supplier, Syngenta was among the few companies in the European chemicals industry which reported better H1 financial results. Syngenta, however, will remain resilient in face of the lingering Covid-19 shock, despite seasonally weaker H2 demand for seeds and crop-protection products.

Companies engage into various Covid-19 countermeasures

Europe's chemical companies have taken various measures to conserve cash as they have faced the region's worst economic crisis since the 1930s, albeit one with an uneven impact on their activities. Managements have focused on: 1) cutting costs; 2) stricter working capital management; and 3) reduction in capital spending. Tight inventory management has been crucial to manage cash while also avoiding supply-chain bottlenecks, hence no reduction in inventory in most company's warehouses.

Figure 3: European chemicals companies respond to Covid-19 shock

Company	Cost reductions	Reduction of Capex	Financial policy/ other support
Air Liquide	~EUR 200m	None	-
Akzo Nobel	~EUR 120m	None	-
Arkema	Undisclosed size	EUR 100m	-
BASF	Undisclosed size	Undisclosed size	-
Covestro	>EUR 300m	EUR 400m	-
DSM	Up to EUR 30m in the Materials division	Reduction of capex in the Materials division of an undisclosed size	-
Evonik Industries	Undisclosed size	None	-
Lanxess	~EUR 50m	~EUR 50m	Cancels EUR 500m share buyback programme
Linde	Around USD 380m	Up to USD 200m (following lower capex guidance)	Paused share buybacks
Solvay	EUR 300m (FY 2020 of which EUR 170m in Q2 2020)	EUR 250m	-
Syngenta	Undisclosed size	None	-

Source: Scope, company data

No major defaults expected, credit quality to worsen slightly

We expect only slightly deteriorating credit profiles overall in the European chemical industry due in part to the measures companies have undertaken to conserve cash combined with efforts by authorities in Europe to cushion business from the recession. In the context of the global chemicals industry, insolvencies are rare. With the exception of the insolvency of Germany's Nanogate AG, we have recorded no bankruptcy of a listed chemicals company. As shown in **Figure 1**, BASF, Linde, Air Liquide and Syngenta have accumulated the most net debt. BASF posted a significant drop in H1 EBITDA and maintained its dividend payment of EUR 3.1bn, but net debt will fall when it receives proceeds of around EUR 3.6bn from its divestment of its construction chemicals and pigment business. Among other companies, we expect a deterioration in the credit profile of DSM as a consequence of the debt-financed acquisition of Austria's Erber Group. We expect the credit profile of European companies to evolve as follows in **Figure 4**, based on our assumptions of how end-markets will develop and how management allocates capital and adjusts financial policies in the second half.

Figure 4: Projected development of European chemical companies' credit profile in 2020

Company	Indication of development credit profile in H2 2020
Air Liquide	▲
Akzo Nobel	▲
Arkema	►
BASF	▼
Covestro	▼
DSM	▼
Evonik Industries	►
Lanxess	▲
Linde	▲
Solvay	►
Syngenta	►

▲positive trend expected; ►stable trend expected; ▼negative tend expected

Source: Scope

Liquidity: companies tap bond markets, refinancing in focus

The European public debt market came to a near standstill in March as governments implemented drastic lockdowns across most of the region. However, as the market reopened from April as the EU and ECB rolled out their multibillion-euro assistance programmes, debt issuance by European non-financial corporates has surged, including from companies in the chemicals sector. Bond issuance has been running at record levels of almost twice the five-year average over the past four months.

BASF issued the first green bond in the chemicals industry (volume: EUR 1bn; duration: seven years). Among the biggest sector offerings, privately held Switzerland-based fragrance and flavour supplier Firmenich SA issued a EUR 1.5bn bond, made up of two EUR 750m tranches while. Akzo Nobel issued EUR 750m, both in April. Most proceeds were used to refinance existing debt, ensuring no net increase in indebtedness. We expect no surprises in short-term debt cover, as the investment-grade companies we track are maintaining comfortable ratios of internal and external liquidity coverage.

Restructuring, balance sheet strengthening serves sector well

The chemicals sector is mostly well set to cope with a temporary drag on operating cash flows as most European chemical companies have used the years of growth since the global financial crisis to clean up their portfolios and bolster their balance sheets (see: Europe's streamlined specialty chemicals companies braced for tougher times ahead).

Near-term outlook: potential to improve; economy's performance in 2021 crucial

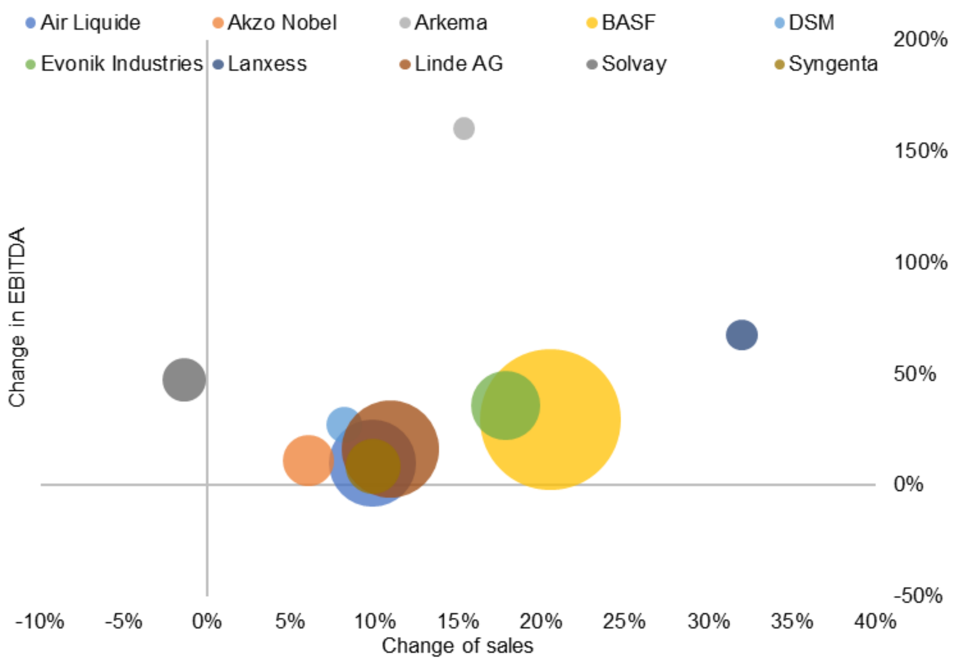
We see potential for a mild recovery for the chemicals sector in Q3 and Q4, assuming no significant second wave of Covid-19 infections in Europe. That said, due to the seasonality of the industry, Q4 typically represents the quarter showing the weakest performance of the year.

Demand for hygiene and consumer-related products should normalise after the strong Q2 upswing. In contrast, Q2 de-stocking could help boost demand for numerous intermediate products in the months ahead. Prospects are also improving in some of the hardest hit sectors such as automotive. Evonik, LyondellBasell Industries N.V. and DuPont de Nemours Inc. have identified rebounding demand for plastics in the industry. However, a clear weak spot is the air transport market, based on the low level of air travel and demand for new passenger planes.

We believe the outlook for global economic growth in 2021 is critical for the sector.

Some cause for optimism may lie in the strength of the industry's recovery after the global financial crisis (see Figure 5). The European chemicals industry recorded a 16% drop in revenue and 16% decline in EBITDA in 2009 but went on to show several years of robust growth.

Figure 5: European chemical companies' change revenue, EBITDA (%, 2011 vs 2010); size of circle show size of end-2009 net debt



Note: Covestro was part of Bayer before its spin-off and IPO in 2015. Source: Scope, Company data

If the chemical sectors' main end-markets remain depressed in 2021, even companies with the soundest credit profiles face some measure of impairment. In such a pessimistic scenario, management would have to consider permanent shutdowns of plants, cancelations of green and brownfield projects, particularly in the upstream segment of the industry or reduction of dividend payments to main their rating levels.

For now, we expect conditions to at least modularly improve in 2021. Our credit outlook for the chemical industry remains stable.

Figure 6: Development of demand in selected end-markets in H1 2020 and outlook for H2 2020

Aftermarket	Development in H1 2020	Outlook for H2 2020
Construction	▼	►
Electronics	▼	►
Agricultural	▲	▼
Paper and packaging	►	►
Automotive	▼	►
Health care and pharma	▲	►
Energy	►	►
Transportation	▼	▼
Nutrition and consumer products	▲	▼
Machinery	▼	►
Mining and metals	▼	►

▲positive trend expected; ►stable trend expected; ▼negative tend expected

Source: Scope

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