Mark Godfrey reports on how the Chinese paint market is robust but approaching maturity – increasing the risks for companies burdened with investment debt

China's paint market approaches maturity

As paint company conferences go, the Sankeshu Paint Co's annual Chinese New Year gathering was special. A room of sales executives wearing matching blue suits and red ties were serenaded with 'Zui Mei de Shen Hu' – 'The Most Beautiful Shenzhou My Home', sung by a soprano, before Chairman Hong Jie strode on stage to rally his assembled ranks to shout in unison company slogans, such as "Full product range! Full distribution chain! Full service!"

Indeed, there is much to celebrate: architectural paints specialist Sankeshu has flagged a rise in profits for 2019 from Chinese Yuan Renminbi CN¥376M (US$53.48M) in 2018 to CN¥420M (US$59.7M) last year. The firm is thriving, thanks to its investments in branding, distribution and capacity expansion, explained Chen Bo Yang, an Analyst at Zhong Xin Securities. "The profitability outlook is good for Sankeshu in a more consolidated market as the company has premium pricing power," said Chen.

Capacity expansion spending at paint and waterproof coatings specialist Oriental Yuhong Waterproof Technology Co Ltd (Dong Fang Yu Hong) grew from CN¥260M (US$37M) in 2012 to CN¥1.72bn (US$244M) in 2018, according to Huaxi Securities Co Analyst Qi Shu Yang, who sees the build-out as a strategy to seize market share by outspending smaller Chinese peers who are ultimately forced from the market, thus allowing bigger players like Yuhong to charge higher prices.

The big challenge is in ensuring cash flow keeps pace with capacity expansion, said Qi Shu Yang, who believes the company will now curtail capacity expansion to focus on debt reduction.

It is a similar story at Sankeshu. Worryingly, even as capacity rose by 80% between 2018 and 2020 (from 735,000t/yr to 1.05Mt/yr), the company's gross margins fell by 160% in 2019 as it battled competition. Sankeshu needs to increase revenue by 16.5%/yr in order to service its debts and pay for capacity expansion, according to Chen Bo Yang.

Sankeshu investors include Swiss bank UBS, which was attracted by the firm's access to China's consumer markets. Yet with US$523M in revenue in 2018, Sankeshu remains small by the standards of international peers like America's Sherwin-Williams, which reported revenues of US$14.5bn for the same year.

Investors nonetheless look to Sankeshu's exposure to the real estate sector and consumer demand. Sankeshu has been successful at branding, notes Zou Ge, an Analyst at Guangfa Securities Co Ltd, and will have benefitted from the 'guo huo' (national products) campaign that gripped Chinese social media during the Sino-US trade war. "The paint market in China is a big industry with small players, so there's room for increased profit growth [by Sankeshu] as consolidation accelerates," said Zou Ge.

One of Sankeshu's branding campaigns centres on its 'Health plus' ('Jiankang +') range of paints, targeted at younger homebuyers: the company has achieved certification from overseas bodies, including Germany's Blue Angel certification scheme and the USA's UL GREENGUARD Gold Certificate.

REAL ESTATE AND THE COATINGS MARKET

Chinese paint production will expand from 22Mt/yr to 25Mt/yr between 2020 and 2025, according to the China National Coatings Industry Association (CNCIA) [prediction is based on figures obtained prior to the COVID-19 pandemic]. Yet there are real risks to this scenario materialising – and those risks include a falloff in the Chinese and wider Asian real estate markets. Real estate prices have started to slide in key cities like Beijing. Sales dropped 8% yr-on-yr in 25 tier-two and tier-three cities in October [2019], traditionally the busiest period for real estate transactions inked during the National Day holiday (October 1). Soaring personal debt – US$6.8trn nationwide – has also contributed to a fall in automotive and housing sales. That suggests a mismatch in property construction and purchasing, which will suppress new demand for paint.

"Housing remains a 'grey rhino' [a neglected risk] due to leverage; if prices fall, then repayments fall," noted Alicia Garcia Herrero, Chief Asia Economist at the Hong Kong offices of Natixis, a French investment bank.

An insight into the Chinese market for architectural paints and decor was offered by the IPO earlier this year of Wenye Group Holdings Ltd, a major Shenzhen-based decorating company: it ranked number 28 in a 2018 ranking of China's decorating market by Frost & Sullivan Ltd. Seeking to raise money to grow its market share (Frost gave it a mere 0.03% market share in revenue terms, underlining how fragmented the sector is), the company in its prospectus valued the Chinese building decoration market at CN¥3.6trn (US$512bn) in 2014 and CN¥4.9trn (US$697bn in 2018), suggesting an average annual growth rate of 8.8%. The decoration market for residential buildings grew an average 10% in that same time frame, according to Wenye (which hired Frost & Sullivan to provide the research for its prospectus). Weyne is anticipating a growth rate of 5.6% between 2019 and 2023, when the market would be worth CN¥6.6trn (US$938bn), according to its projections.

However, growth will be slower (4.8%) in that time frame for public buildings, which comprised 55% of the overall market in 2018. Similarly, whereas growth for painting/decoration of public infrastructure averaged 11.2% between 2014 and >22

Dr Kai Pflug, Management Consulting – Chemicals and *Daniel Philip Senger*, CDI Global, discuss the latest trends shaping China's coatings industry, including environmenntal regulations, consolidation and automation

Trends and developments in China's coatings market

Similar to the situation for the chemical industry as a whole, China's coatings market is by far the biggest globally, accounting for about 33% of the global market by value and an even higher share by volume. In addition, while growth of the Chinese market has slowed down in recent years, it is still higher than the global average, resulting in a further increase in China's global share in the future. The market is far from static, with a number of factors including tightened environmental regulations, a shift towards higher-end products and increasing labour costs pushing the industry towards consolidation.

We start with environmental regulations, a factor that has affected the coatings segment even more than most other chemical segments. Solvent-based coatings have become less and less welcome in some of the more developed cities and provinces. For example, in May 2018, Shanghai prohibited the use of solvent-based coatings for exterior walls and woodware in construction. On the same date, Shenzhen completely forbid the use of solvent-based coatings and solvent-based adhesives. In Tianjin, solvent-based coatings were prohibited for use in vehicle maintenance in early 2019. Apart from these individual prohibitions, another driver for the replacement was the introduction of environmental taxes on VOCs including benzene and toluene. In fact, the Industrial Structure Adjustment Guidance Catalogue issued by the NDRC in April 2019 encourages low-VOC coatings in water-based woodware, industry, marine coatings, functional exterior insulation coatings and other areas.

Individual companies have reacted accordingly, both by increasing their capacity for water-based coatings and by closing down capacity for solvent-based coatings. For example, Chongqing Three Gorges in May 2019 announced the construction of a water-based industrial coating production line with an annual capacity of 25kt, which will replace the existing 10kt capacity of solvent-based coatings.

In addition, since the policy of relocating hazardous chemical production from urban areas into chemical parks was formulated, many coatings companies have need to relocate. For small coatings producers with low-end products and low investment capabilities, a relocation will often be less likely than a complete shutdown of the plant, particularly as chemical parks become more and more selective in their choice of tenants. Incidentally, this may also further push the coatings industry towards western China. Sichuan is already the fourth-biggest coatings producer among the Chinese provinces and while places like Shanghai and Jiangsu suffer from very strict implementation of environmental regulation, chemical parks in Sichuan still are quite open to new entrants.

CONSOLIDATION OF THE MARKET

Overall, these phenomena will enhance the ongoing consolidation of the industry. In some way, it is long overdue. At the end of 2015, China had about 10,000 coatings producers, of which only about 2000 reached annual sales above RMB20M. Of the 8000 smaller ones, about 4-5000 closed down or suspended production in the last three years as a result of tightened environmental regulation. But even now, the top 100 Chinese coatings producers account for only 49% of Chinese sales. Similarly, while eight of the top 80 global coatings companies are headquartered in China, they are quite small compared to the biggest global players, with the two biggest Chinese players (Shanghai Huayi Fine Chemicals and Xinjiang Paint Group) only reaching number 26 and 28 in the list. Also, none of the Chinese players so far have any substantial presence abroad.

Consolidation pressure also arises from the need to develop new, more environmentally friendly products. Those companies that cannot afford to invest in R&D will be pushed out of the market sooner or later, unless they manage to sell themselves to larger companies before being forced to shut down. In contrast, some of the larger domestic coatings companies have recently expanded their R&D activities and subsequently introduced a number of new products. For example, Bardese achieved three R&D successes related to wood coatings, including achieving a transparent effect on solid wood, achieving a flat levelling effect and achieving a coating mix of powder base + water-based surface. Zhanchen developed a water-based UV-curable wood coating that can be cured by conventional UV light sources or LED cold light sources.

Another indication of the ongoing consolidation is the continuous and substantial investments of the leading players in additional production capacity and new products, with examples including the following:

- AkzoNobel is adding three new production lines at its Changzhou powder coatings plant in China
- Asia Cuanon is constructing a new production base in Changsha, Hunan, an investment of RMB600M, which will provide an annual production capacity of 200kt for architectural coatings
- Axalta will focus on the high-end powder coating market, introducing new product lines and service models. Its flagship brands will be relaunched with new Chinese names.
- BASF will construct a new facility for automotive refinish coatings in Jiangmen, Guangdong that will start production in the first half of 2022
- Carpoly will establish facilities for production of construction materials (500kt/yr) at the Anhui Mingguang

Economic Development Zone, including coatings

- Hempel will invest US$170M in Zhangjiagang, adding a total of 200kt annual production capacity of marine coatings, industrial coatings and waterborne coatings
- Keshun held the foundation ceremony for the Fujian Keshun New Material Intelligent Production and Production Base Project in December 2019
- Oriental Yuhong put several production lines in operation in September 2019, including one with an annual output of 40kt of water-based paint and one with an annual output of 100kt of polyurethane waterproof coatings
- PPG will construct a South China R&D and production base from 2020 to 2022, an investment of RMB620M
- Sankeshu (3trees) opened its Anhui Sankeshu Eco-industrial Park in April 2019, an investment of RMB686M
- Sherwin-Williams opened its new Asia headquarters in Shanghai in 2019, describing it as "a major bridgehead to drive growth in the region"
- UV-ChemTech (Shenzhen), along with Yihua, will invest RMB8bn in Hubei province to construct what is said to be the world`s largest UV curing material project (100kt/yr)

AUTOMATION AND CO-OPERATION

As the industry landscape consolidates and labour costs rise, automation will also increase. Automated coatings production lines not only reduce operating costs but improve production efficiency and product quality. Upon the opening of the Baderse Zhongshan factory in February 2019, the company introduced an intelligent manufacturing system, aimed to improve production efficiency and the stability of product quality. Nippon Paint, Asia's largest paints and coatings manufacturer by sales revenue, planned to automate 28 of its China plants by the end of 2019, stating that this will boost productivity and save on labour costs. Again, automation is a trend that will favour large, consolidated producers over small ones.

Coatings companies are also already very actively looking for co-operation partners in order to strengthen their position. For example, Lanling Chemical aims to co-operate more closely with Sinopec while Oriental Yuhong signed a strategic co-operation agreement with both Celanese and Yanshan Petrochemical.

Coatings manufacturer Chenyang Group announced plans to collaborate more extensively with Dutch chemical company DSM to drive sustainable coating solutions in the Chinese market. Several coatings companies have reached longer-term agreements with real estate companies to supply them with wall coatings, for example Carpoly (with China Railway Real Estate Group) and Cosco. Jotun has renewed its joint venture with Cosco Shipping, a 50:50 joint venture that holds a leading position as China's marine coating supplier for the shipping industry.

Leading Chinese players may in the longer run want to reduce their dependence on the domestic market by targeting markets outside of China. An acquisition of an overseas coatings company is the most promising approach to achieve sales outside of China in a timely manner. A Japanese company, Nippon Paint, has taken a step in this direction in 2019 with the acquisition of Dulux, a move that is to reduce Nippon Paint`s reliance on the Chinese coatings market from 57% of its sales to 47%.

In the long run, the current developments of China's coatings industry are very likely to have a highly positive effect. Industry consolidation will be accompanied by a larger share of high-end, environmentally friendly products, as well as better margins. However, only those coatings companies large and strong enough to survive the current consolidation phase will benefit. For many small players, consolidation will mean having to exit the market, unless they can find a strong partner or buyer for their company. Large companies may want to use this opportunity to acquire assets and brands, or to consider expansion abroad. ■

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2018, that growth will average only 6.8% between 2019 and 2023 as government investment spending cools, according to Wenye.

MULTINATIONAL KNOW-HOW

Meanwhile, multinationals appear to have the edge within China in valuable niches like powder coatings, in a market estimated to be worth US$16.5bn and where international majors hold an 80% share. The Netherlands' AkzoNobel continues to invest in its Changzhou plant, while USA-based Axalta Coating Systems has exited its joint ventures to concentrate on its wholly-owned factories in China.

The know-how of multinationals like Axalta could prove crucial, given that China's automotive market, where tougher environmental compliance could mean a shift towards powder coatings, noted Wu Chunping (Willie Wu), head of Axalta's China operations, speaking to the Chinese business press.

Updates of four key laws have had an impact: the Environment Protection Law, updated in 2014; the Law on Prevention and Control of Water Pollution, updated in 2017; a Law on the Prevention and Control of Air Pollution, updated in 2018; and the Law on the Prevention and Control of Solid Waste Pollution, updated in 2016.

Axalta has also increased sales by offering training, as well as products to auto OEMs and independent body shops across the country to help them meet tighter environmental regulations. The firm is collaborating with the CNCIA to deliver 'Green Coatings Training' sessions nationally.

Meanwhile, e-commerce tie-ups are also boosting the industry – for instance, a strategic co-operation deal between Nippon Paint Co Ltd, of Japan and Qi Jia Online Market (jia.com), which operates the country's leading online decoration portal and is popular with younger consumers, who use the site to choose decor contractors and materials.

Yet Jia.com has, however, projected a loss for 2019, with a rise in complaints from customers over materials and workmanship – suggesting it may take some time before the business is profitable.

Finally, with China's paint market approaching maturity at 13.7kg per capita, Chinese consumption of paint is approaching the 17.5kg per capita seen in the US, causing Chinese manufacturers to consider export opportunities, according to the CNCIA.

A CNCIA-led delegation of Chinese paint and coatings firms visited South Africa in 2019 to explore demand. A similar delegation went to Latin America in 2018, with both trips branded as Belt & Road Initiative tours, leveraging the government's plan to expand sales of Chinese goods through the construction of infrastructure backed by Chinese loans. ■

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