

How does the future colour of the paint sector look like?

Coating manufacturers have to re-think their long-term positioning

Dr. Tobias Lewe

Especially in Europe the devastating impact of the economic downturn on industries such as automotive and construction dramatically hit coatings suppliers. Even though recent signs of hope suggest that the worst is overcome, the economy is quite far from having recovered from the crisis. Yet, no matter how uncertain the economic outlook is, there are important opportunities ahead – such as those arising from backlog in demand in developing countries, ongoing restocking across customer value chains or the various economic stimulus programs.

A closer look at the geographical impact of the economic crisis reveals that in Western Europe the impact has been particularly dramatic: While global market volume is estimated to shrink by 7 % (from USD 93 to approximately USD 86 billion) from 2008 to 2009, the Western European markets will most likely experience a contraction of more than 20 % (from USD 26 to 21

billion). This is a remarkable trend reversal, given that since 2005 global and European coatings markets have been growing with an average yearly growth rate of 6 % and 2 % respectively (fig.1).

In spite of plummeting earnings, leading coatings manufacturers successfully managed to control their cash flows. Recent analyses of major players show that in the first half of 2009 their operating cash flow went down less than 10 % while EBIT margins decreased by almost half compared to 2008. Indeed, companies have taken all-out efforts to counter the economic crisis: They tried to cut fix costs by consolidating production, closing warehouses and rigorously optimizing net working capital to stabilize balance sheets.

Touchdown ... and now?

Meanwhile, there are signs suggesting that global recession is lifting. Nevertheless, as the demand for coatings products heavily depends on industry development in key customer industry sectors, the mid- and long-term cyclical outlook continues to be difficult to predict.

Corresponding Author:

Dr. Tobias Lewe
A.T. Kearney GmbH
Germany
T +49 211 1377 2768
tobias.lewe@atkearney.com

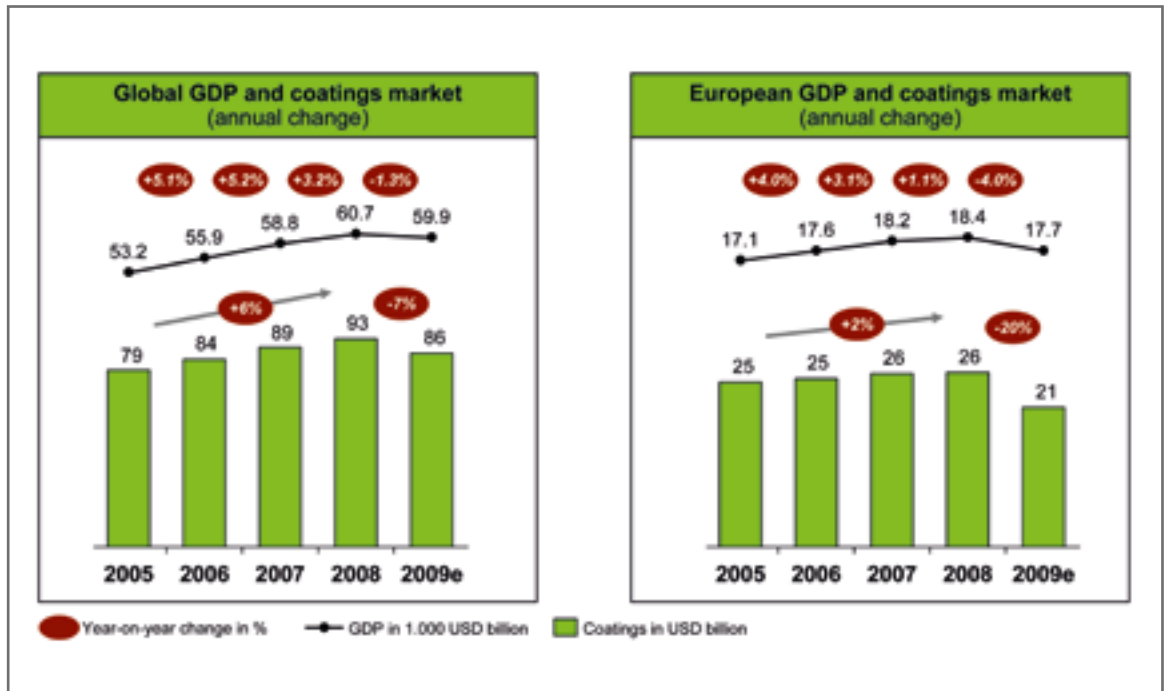


Figure 1: Global economy and coatings market development

Source: IMF, GIA, Euromonitor, Orr & Boss, company reports, A.T. Kearney assessment

At present, the expert consensus tends to veer towards a U-shape-scenario according to which global market for coatings will likely bottom out in 2010 and reach its 2008 level again in 2011/2012. For the time being, price-based competition is likely to keep pressure on margins. At the same time restructuring programs under way entail additional short-term charges and will most likely only make their full positive impact in 2010.

Presupposed however, current pick-up in demand is mainly due to restocking effects – and relief therewith overestimated – a double-dip-W-shape-scenario in which the first recovery will be followed by a setback becomes likely (fig. 2).

Beyond that, the future economic outlook differs very much according to the segment in which a company is operating, as the crisis did not have the same impact on all sectors. The automotive industry, for instance, has been affected immediately and very severely. State programs led to some relief in 2009 but the outlook for 2010

remains uncertain. The construction sector as well suffered a severe decline. Meanwhile it shows short-term recovery, to which the substantial economic stimulus programs made a major contribution. Engineering companies, in turn, were reached by the crisis with some time lag.

Compared to other segments specialty segments, e.g. powder coatings, clearly show less margin pressure and above average growth. Decorative coatings benefit from a continued growth of construction activities in emerging markets, sound renovation spend in mature markets and the expansion of DIY chains (fig. 3).

Where do we go from here?

Regardless of the economic scenario that will ultimately come true, at long sight the coatings industry bears important growth potential, mainly driven by the enormous backlog demand from developing economies: While in

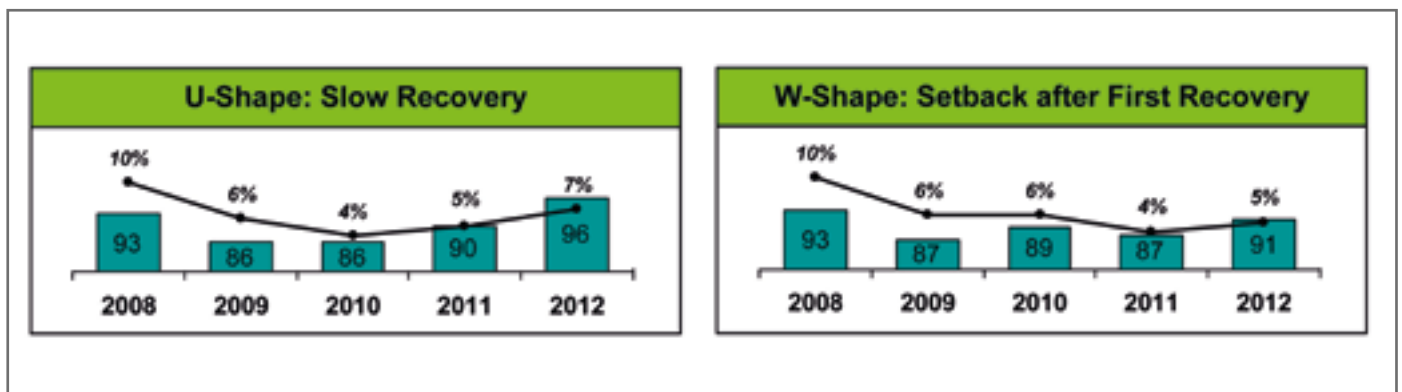


Figure 2: Scenarios for the coatings industry

Source: A.T. Kearney

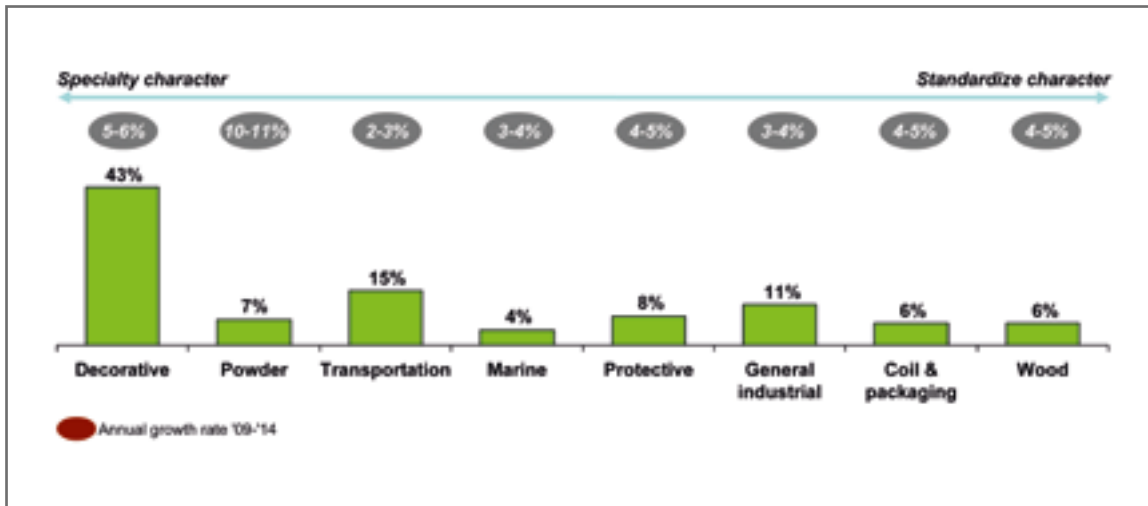


Figure 3: Coatings market by customer segment (2008, by value, in %, selection)

Source: Euromonitor, Akzo-Nobel, Orr & Boss, Sal. Oppenheim, A.T. Kearney

mature markets like North America, Western Europe and Japan – where per capita consumption amounts to more than eight litres – coatings are growing in line with GDP, they are growing above GDP in emerging markets like most parts of Asia/Pacific. This compensates for the significantly lower per capita consumption of between two and four litres. It is expected that Asia-Pacific will have outperformed Europe in terms of market size by 2012 at the latest (fig. 4).

Western Europe – which is today the most important coatings market accounting for more than one third of market volume – is losing ground as important customer industries like metals or furniture are increasingly shifting their production to lower cost locations such as Eastern Europe and Asia, in particular China (fig. 5).

Strategies for a bright future

In this tense market environment coatings companies that want to gain and retain a pivotal competitive advantage won't get around re-thinking their long-term positioning and adjusting their business model to best exploit the opportunities ahead. One decisive success factor for future industry leaders is a regional footprint, which allows companies to benefit from worldwide growth in key regions. Moreover, companies need a balanced portfolio, which enables them to address regional customer specifics and focus on market segments with stronger growth and margins. Furthermore a competitive edge won't be gained without innovation. Sources of innovation – and differentiation – range from value-added coatings with particular technical specifications to process innovations such as performance guarantees. Finally, financial health is key. By better managing complexity and controlling net working capital companies can generate cash – and therewith funds then can be invested in R&D or enable the company to take an active role in market consolidation. Compared to previous years EBITDA deal multiples dropped to significantly lower levels which may be an indicator for attractive M&A opportunities. Hence for those companies, that actively manage their fortune, the future looks bright. ◀

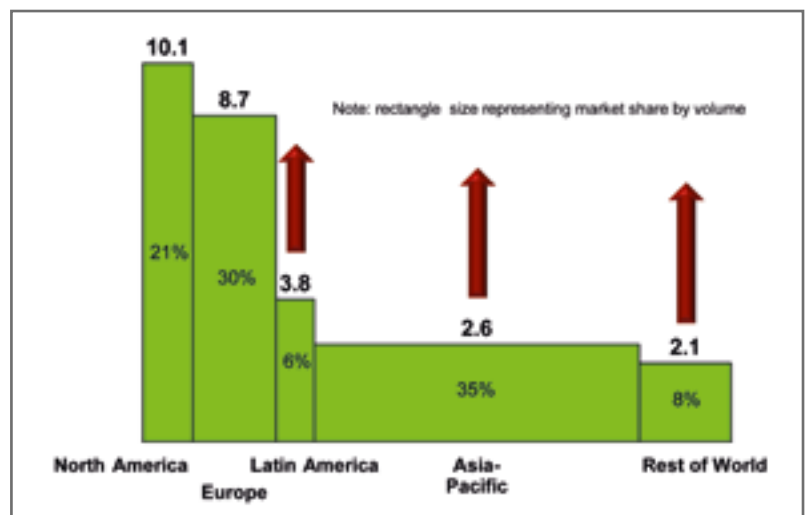


Figure 4: Coatings demand per capita (in l, 2008 by region, volume market share in %)

Source: Akzo Nobel, Orr & Boss, Sal. Oppenheim, A.T. Kearney assessment

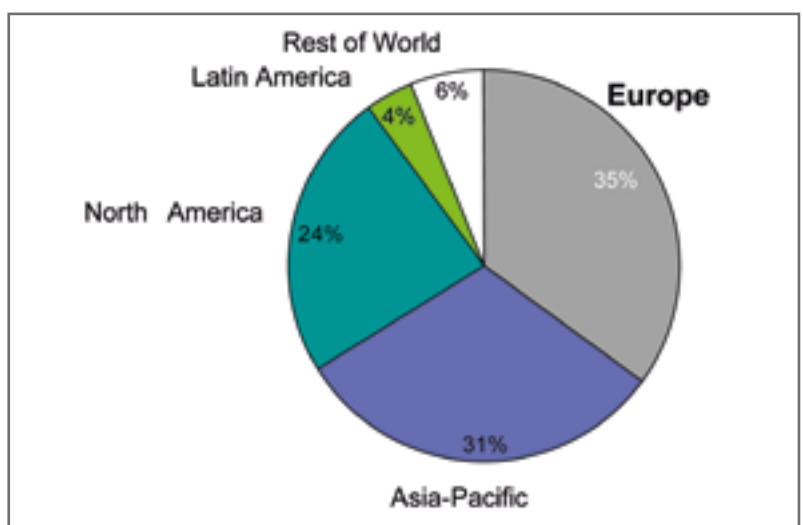


Figure 5: Coatings market by region (2008, by value, in %)

Source: Euromonitor, Akzo Nobel, Orr & Boss, Sal. Oppenheim, A.T. Kearney

Combined efforts

2010: Staying competitive in challenging conditions

Miriam von Bardeleben

Towards a year's end it is interesting to see how the leaders of the European coatings industry look into the future – are they optimistic or not? The stories about development in 2009 mostly sound similar: sharp market drop, slow recovery expected.

But there are also voices questioning a recovery in 2010 – be it quick or slow. The situation remains fragile, even though the free fall may have come to an end. To what extent will 2010 be another challenging year for the European coatings manufacturers, when it comes to maintaining competitiveness? What can be done to enhance a positive development?

Across all coatings segment, the drop in demand was more or less severe, and according to CEPE the automotive coatings sector was worst off with numbers sinking by up to 30 %. Surprisingly there have been coating segments, which remained rather stable in this turbid period (*page 10*).

Waiting for authoritative forecasts

After sinking demand in 2009 market analyses expect the coatings consumption to recover until 2014 (*chart*). Ahead of all other regions, Asia-Pacific shows increasing coatings demand, but growth potential can be seen in mature markets like Europe, too.

Many players in the market are willing to believe that the worst has been overcome in the ongoing crisis. But doubtful voices suspect that some of the fairly optimistic scenarios which are published nowadays may be tailored to promote the impression that the economic decline is over. The consensus seems to be that “the chicken should only be counted when they are hatched”, so that the coatings industry is still waiting for an authoritative forecast based on industrial indicators that would convince everyone that the decline has bottomed out.

Careful about cost reductions

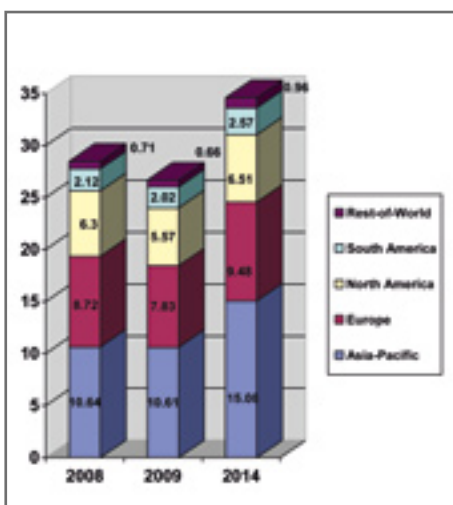
Cutting costs has been one of the central issues during the past months. But most coatings manufacturers have recognized that though they have to take a number of measures regarding costs, it is more useful to be selective in investments rather than stop them altogether. Experts warn that with a decision towards too rigorous cost reductions one might be start cutting the bone instead of the fat. A possible result could be to endanger the foundation of future high-end innovation, which is desperately needed to prevail in the long run.

Planning for growth

Although the economic weather forecast does not sound too promising, numerous European coatings manufacturers are planning a growth in sales for 2010, believing primarily in their own strength and in their markets. Every company aims at positioning itself to meet the current challenges, and then as a result be in a good shape to take advantage of the recovery when it comes. One also finds examples of companies that even did quite well during the last twelve months. Jotun is one of these. According to their President & CEO Morten Fon they have achieved higher sales by approximately 10 % in 2009. Fon expects to grow the company's market shares further until the end 2010, although at least of Jotun's core markets, the marine coatings, is expected to become weaker.

Rethinking long-term positioning

After the crisis it will be a hard struggle for the European coatings industry to get back to the numbers of the past. However, the changed face and structure of the majority of players will most probably not change back to former levels at all. “In this tense market environment coatings companies that want to gain and retain a pivotal competitive advantage will not get around rethinking their long-term positioning”, explains Dr Tobias Lewke, A.T. Kearney. The consultant is convinced that business models will have to be adjusted in order to best exploit the opportunities of the future. Read his article (*page 11*) to get inspiration e.g. on the two following questions: Where do we go from here, and what strategies sound promising enough to lead into a bright future? One thing is for sure: Without the combined efforts of companies, associations and institutions the challenges ahead will be hard to be overcome. ◀



Global coating consumption by region (MM tons)
Source: Kusumgar, Nerlfi & Growney, Inc.