Will The Future Bring Growth And Sustainability?

Distributors Rethink Financing, Services and Staff Development

Publication of the 2014 figures of Brenntag, DKSH and IMCD has shown that last year was a good one for chemical distributors. Sales growth was moderate, but measures to increase efficiency paid off, and the companies showed improved results. Mid-sized, privately owned distributors are not obliged to publish data, but when asked in private, they will mostly agree that business in 2014 was indeed quite good.

But what will the future bring? The theme of this year's FECC Congress is "Towards a Sustainable Future," and the speakers will address topics such as "Success Factors in the Chemical (Distribution) Industry" or "How to Plan for the Long Term?" In this context, it is worthwhile to review where the industry is headed and what individual companies can do to become or remain successful.

Quoted Distributors Bring More Transparency

Last summer IMCD joined the ranks of the few publicly listed chemical distributors. The initial public offering at the end of June on the Euronext exchange in Amsterdam was oversubscribed. The shares are trading about 50% above the offering price.

Successful IPOs and the growing list of quoted distributors are certainly attracting more attention to the industry as a whole, as more asset managers and other institutional investors have taken an interest in the industry. The larger companies are now getting regular coverage from analysts at banks and other financial institutions or even rating agencies, such as Moody's or Standard & Poor's, for the bonds they have issued. This brings transparency but also pressure to perform and the need for sound compliance and good governance.

What Else Will 2015 Bring?

According to the International Monetary Fund, global growth is forecast to rise moderately in 2015-16, from 3.3% in 2014 to 3.5% in 2015 and 3.7% in 2016. Unfortunately, Europe is more subdued, with an expected growth rate of only 1.2%,
despite certain "supporting factors" such as a lower oil price and a depreciation of the euro.

As the chemical industry is feeling the effect of the significant decline in crude oil prices since last summer, distributors cannot escape these developments.

Headline sales might therefore suffer somewhat in parts of the industry. However, gross margins tend to move less strongly than the underlying product price levels, and measures to increase organizational efficiency should help the bottom line.

The devaluation of inventories can cause problems, when sudden negative price swings need to be absorbed and companies have gone long on the products they store. The strengthening U.S. dollar will also influence companies that import into Europe and will make dollar-denominated purchases more expensive. With these crosscurrents, companies do well in assessing their own specific situation and taking appropriate action. Prudent management and a strong underlying financial position will help companies maintain and even improve their market positions.

**And What About M&A?**

The recently announced sale of Azelis by 3i to global private equity house Apax Partners is one of the larger deals in the history of the industry. 3i had been invested in Azelis since late 2006. It appeared that they were running out of steam a bit. Apax Partners, on the other hand, is new to chemical distribution, and it will certainly bring some fresh views to the business. As the announcement of the transaction clearly spelled out the global ambitions and the international growth plans, this new investor can be expected to aim high, maybe for Azelis' IPO in a few years.

But medium-sized distributors also conclude transactions. The main drivers, our analysis of 2013-14 data suggests, are gaining access to new applications and broadening the geographic coverage, mostly within Europe.

**Financing Growth**

To finance their growth plans, companies typically rely on their own free cash flow, particularly when the owner families have only a few members and a strong philosophy of reinvesting a large portion of the profits back into the business.
Or companies can access the capital markets. However, this is often a viable route only for larger, listed or private-equity-backed companies. When private companies have an ownership structure in which some family members require a steady dividend stream, alternative forms of financing must be found.

Recently, Dutch specialty-ingredients distributor and food- and feed-additives blender Barentz International has tapped the financial markets by obtaining "growth capital" from an unnamed family office as a minority equity partner in the company. Several examples from Germany show that the use of mezzanine capital seems to be getting a good reception. Only a few weeks ago, Overlack obtained a tranche of growth financing from Hannover Finanz, in the form of a convertible loan. Biesterfeld obtained the same form of financing in January 2011. That particular loan, provided by the same investor, was converted into a minority shareholding (28.6% of the capital) in the holding company of the group last October. But also smaller distributors, such as Velox, have resorted to participation rights as a way to finance growth initiatives. Taking on mezzanine capital appears to be a lot more palatable than an outright sale of a minority share of one's family-owned company to a financial investor.

**Services As A Differentiator**

A number of distributors try to differentiate themselves from their competitors by providing a selected range of services besides the chemical product as such. Typical examples are application laboratories, which are mostly found in cosmetics/personal care, food and nutrition, and pharma, but also in technical applications such as paints and coatings, homecare/industrial and institutional cleaners, or adhesives.

The aim is to provide a body of product and application knowledge, helping to develop research formulations and explaining new application opportunities or product features, in order to position a premium product range. Another task is competitive matching - to get products into existing formulations with ingredients and additives from other suppliers. The laboratories and the standard equipment items are operated by the distributor's technical staff, tests and developments requiring more specialized analytical equipment and skills are outsourced to third-party service providers.

Laboratory services are typically used as a marketing and sales tool and not charged for separately. In that sense they are "freely available," as a large distribution group claims on its website. But some distributors are discussing whether they should charge a fee for the service, separate from the product price.
The key question here is the market's readiness for this. While this may generate an extra contribution margin, it leads to questions of positioning of the offering and the liability assumed, e.g., for the accuracy and validity of test results, which have to be addressed beforehand.

Another service element offered by some distributors, which has gained a lot of attention over the last few years, is the provision of regulatory advice. In Europe, where a whole industry of expert consultants developed in the wake of REACH (Registration, Evaluation, Authorization and Restriction of Chemicals), this may not be a unique offering. But in other geographies, where tighter chemical regulation is more recent and often available only in local languages, such an expertise is very valuable, particularly to chemical producers who are planning to sell locally, either direct or via a distribution partner. DKSH, for example, has built up a sizeable team of experts, both in Europe and in Asia. The availability of such resources could very well be one of the deciding factors when suppliers select a distributor.

When principals contemplate working with distributors as a channel to market, one concern is often the fear of losing touch with the market. Distributors can alleviate that concern by offering regular reporting, particularly of project activities. This may require the investment in a suitable CRM system, and, where this is already in place, some modification to the existing setup, to implement an automatic interface. This is often supplier-specific, so projects in that field can be quite time-consuming and challenging. However, when it's all up and running, the ability to generate informative and meaningful reports at the push of a button never ceases to impress.

**Professionalization Of Staff**

A number of distribution companies have reached a size where the need to put adequate management structures in place can no longer be neglected. Only then can the required level of "unité de doctrine" be ensured and complexity managed efficiently.
Systematic human resources management becomes an ever more important success factor. Training and development of management can no longer be outsourced to the chemical industry, in the hope that when the need occurs, senior management candidates can be searched for, identified, selected and hired from the outside. Distribution of chemicals is fundamentally different from manufacturing of chemicals: It is about building and maintaining relationships versus efficiently utilizing assets, to use a simplified comparison. The distribution industry must develop its own management pool more systematically than in the past, in order to be able to drive further expansion.

In this context, it has been interesting to see that Brenntag has recently appointed the group's first global human resources director. It might not be long until other large distribution groups with global aspirations will follow.

"Mind the Gap - In the Middle"

While industry consolidation will no doubt continue, large multicountry or even global distributors will coexist and compete with numerous local players, only active in a specific country or geographic region. Both groups can be successful, depending on how good they are at meeting the needs of the often-global principals and the mostly local customers they serve.

The large players, being listed, private equity or family-owned, will continue to grow as they roll out their business models further. Such a growth trajectory is not without pitfalls, as the local customer contact still counts a lot and must be combined with measure to reduce complexity and maintain or enhance efficiency. But financial strength and prudent management enables them to further expand their position in the industry.

Smaller companies, who typically enjoy close customer contacts and often deep insights into the workings of their target industries, must work on their attractiveness to leading producers of chemicals. Large principals are expecting a level of service that requires investments in infrastructure and people. Small companies must decide where they want to compete and then focus on defendable niches. Only then can they afford to fund the growth projects and the infrastructure required, be it in a laboratory or a modern CRM system that can generate timely project reports to support customers and enable close cooperation with suppliers.

But there are also companies that can best be described as "caught in the middle." These are distributors that are no longer operating only in attractive and defendable niches or that are financially and management-wise not strong and
confident enough to grow by attracting new suppliers or moving into adjacent geographic markets. Owners and managers of such companies need to make some really hard choices in order to stay clear or get out of the danger zone. And for some, this may make it sensible to exit certain industries or countries or even to sell out altogether, so that a combined business under different ownership has a more sustainable future.

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