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A winning formula for specialty-chemical conglomerates

An analysis of top-quartile specialty-chemical companies reveals important implications for value creation.

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Specialty chemicals is a diverse market that includes more than 50 chemical value chains across a broad spectrum of products, such as additives, adhesives, flavors, and engineering polymers. Market players include both pure-play companies focused on only one or two value chains and conglomerate players that participate in multiple chains.

As specialty chemicals industry executives optimize their portfolios to maximize shareholder value creation, the long-standing question is whether a conglomerate model is a winning play. At the highest level, the answer has historically been "no." However, the question warrants a more nuanced analysis.

We looked at nearly 100 public specialty-chemical companies and compared the return on invested capital (ROIC) of top-quartile conglomerates and pure players over the past 20 years. Our findings were enlightening: Not only do pure players generate much higher ROIC, but the gap has widened over time. The median specialty-chemicals conglomerate delivers six percentage points lower ROIC than pure-play companies. Furthermore, the gap increases to 11 percentage points for top-quartile players (exhibit).

Decomposing ROIC into its key drivers—margins and capital turnover[1]—reveals the critical difference is found in capital turnover. In fact, top-quartile conglomerates have fully caught up on margins over the past eight years.

This finding informs two important implications for specialty-chemical conglomerates:

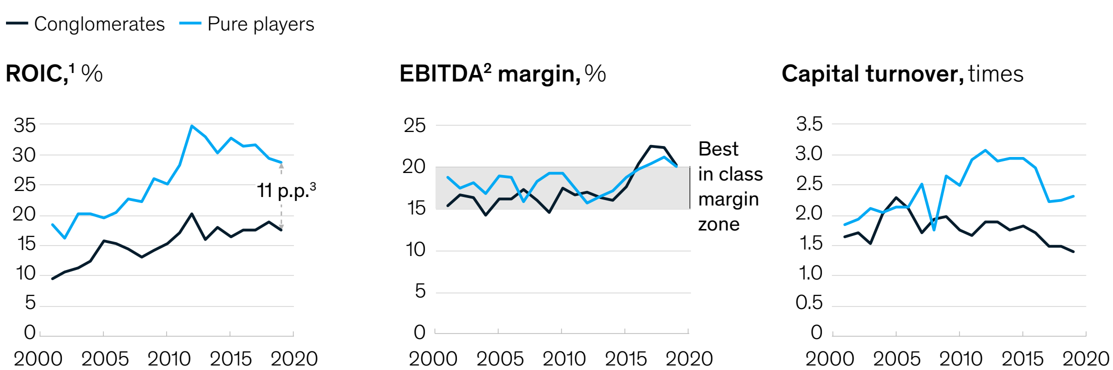
— *Margin improvements only go so far.* Once players reach top-quartile earnings before interest, taxes, depreciation, and amortization

[1] Capital turnover defined as revenues divided by operating invested capital.

Exhibit

Best-in-class pure players generate higher returns, but—driven by capital productivity—conglomerates have caught up on margins.

Comparative performance of top-quartile specialty-chemical companies



[1]Return on invested capital.
[2]Earnings before interest, taxes, depreciation, and amortization.
[3]Percentage points.
Source: Capital IQ

(EBITDA) margins, historically in the range of 15 to 20 percent, further improvements in value are more likely to come from improving capital turnover or growth.

— *Capital turnover is key to closing the value gap.* The most important lever to meaningfully address capital turnover is portfolio composition, driven by the asset intensity of the relevant value chains. Continuous evaluation of the portfolio to seek out additional asset-light, "true specialty" value chains with attractive growth is critical.

Practically speaking, conglomerates should continue focusing on aggressive capital allocation while shifting capital and talent across segments. Doing so could enable them to capture new areas of growth and transfer excess profits to the parent company for future investments. With this in mind, conglomerates are well positioned to drive the next level of value creation in specialty chemicals.

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