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FIGHTING COMMODITIZATION IN CHEMICALS WITH A BETTER COMMERCIAL MODEL

Windfalls on feedstocks and emerging-market growth have masked the margin damage from increasing commoditization.

by Jochen Böringer and Theo Jan Simons

A rising tide raises all boats, and the chemical industry over the past 15 years has had the good fortune to ride not one but two rising tides. Companies have been able to cash in not only on the availability of attractively priced gas feedstocks in the Middle East and the United States, but also on strong emerging-market growth. These value-creating trends have obscured, however, the margin erosion caused by product commoditization across much of the industry. This in turn has been driven by freer availability of production technology, proliferation of producers, and overexpansion of capacity in many product areas (exhibit).

While chemical companies have worked to protect margins with better manufacturing performance, their traditional service-heavy marketing and sales operating models in many cases remain untouched. Indeed, our research shows that average sales, general, and administrative costs as a percent of revenues have risen, by as much as ten percentage points over the past decade.

Matching the commercial model to the degree of commoditization could provide relief. Where margins remain substantial and product development with higher-end customers can create value, a service-intensive approach will still be a strength. For the next tier of businesses, a lower-cost backbone might offer essential services, with the possibility of charging for additional ones such as on-demand technical support. A low-cost digital channel that unbundles service from sales would target customers no longer willing to pay for service. Companies should set up a stand-alone commodity-focused business unit where competitive pressures are so intense that adopting the lowest-possible-cost model becomes essential for survival.

Executives across industries can learn from the chemical experience. If they ride similar macroeconomic trends and updrafts while neglecting the inner dynamics of their business, they risk losing a lot of value. Recapturing that value will require creative solutions. Q

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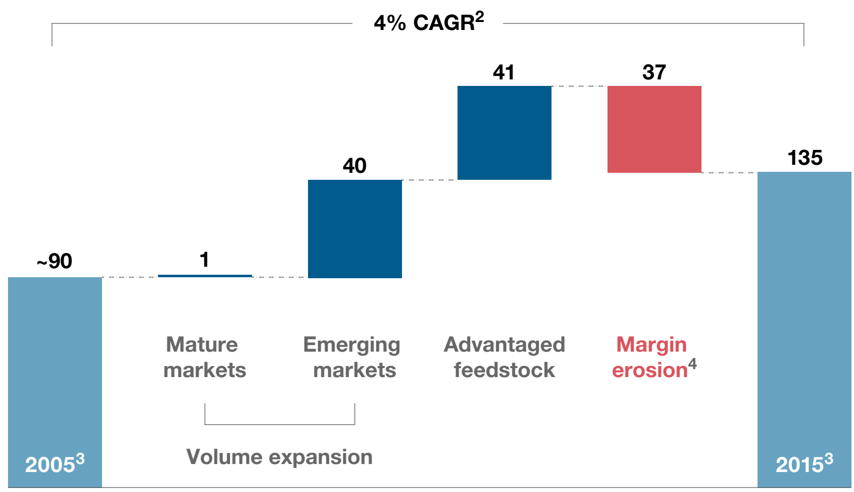
For the full article on which this article is based, see "Commoditization in chemicals: Time for a marketing and sales response," on McKinsey.com.

Exhibit

Margin erosion has dampened gains from volume growth and attractive feedstock prices.

Chemical-industry value pool, EBITDA,[1] $ billion



[1] Value pool covers 90 products; EBITDA = earnings before interest, taxes, depreciation, and amortization.
[2] Compound annual growth rate.
[3] 3-year trailing average.
[4] Primarily margin erosion through product commoditization (especially Asia); netted for >$4 billion margin improvement in Western Europe.

Source: ICIS Supply and Demand; IHS; McKinsey analysis