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Indian Chemical industry: Specialty Chemicals

‘China+1’ strategy adopted by MNC customers and increasing cost competitiveness may result in multi-year growth potential for Indian companies

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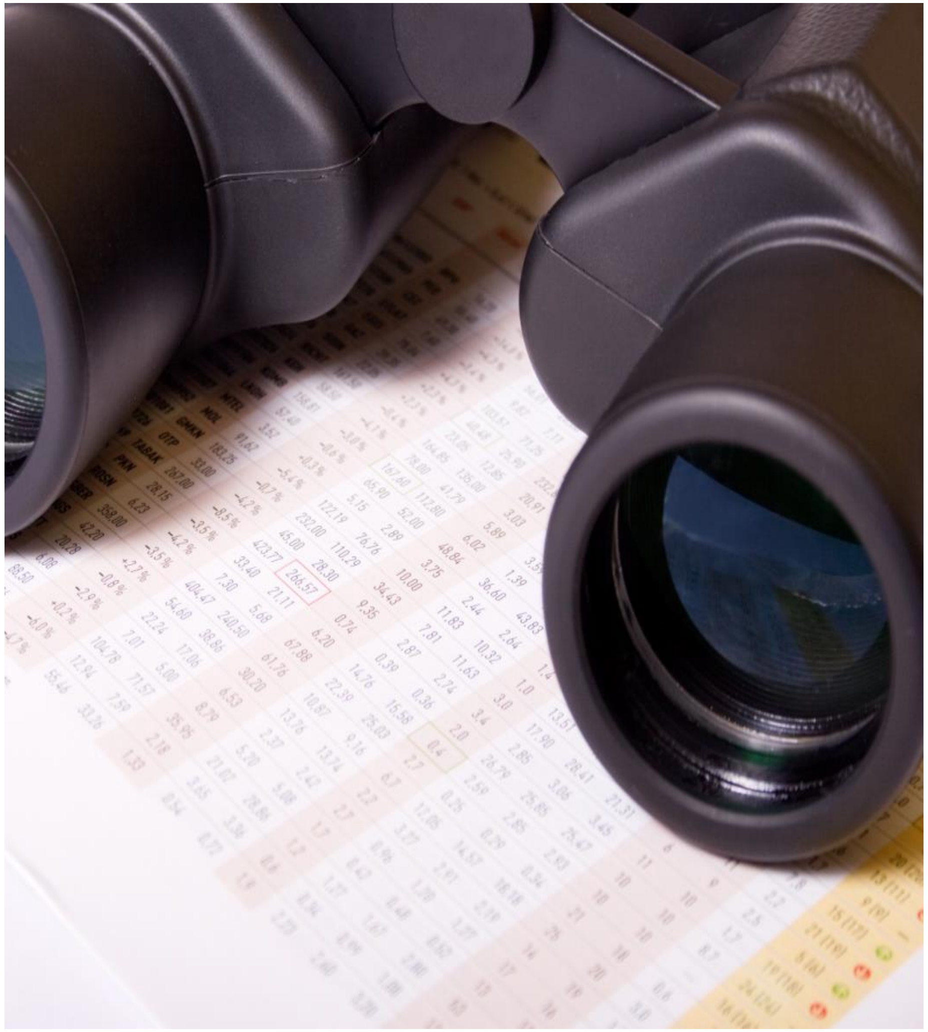
CREDIT OUTLOOK: Stable



- The credit outlook for the specialty chemical industry remains Stable, despite the disruption caused by the Covid-19 pandemic. While, the revenue and margins are expected to witness some adverse impact due to the containment measures adopted, resulting in moderation in performance during Q1 FY2021, however, the impact for the full year will be partly mitigated by the robust export demand in several segments and a sharper domestic demand recovery in certain sub segments. Further, the sector is also expected to benefit from potential changes in the global supply chain with global chemical majors looking at diversifying their dependence on China and the Indian companies are well placed to get a healthy share of the opportunity. The credit outlook is also supported by a relatively robust balance sheet of the players with moderate gearing and comfortable coverage indicators, despite some of the major players incurring debt-funded capex in recent years. **Further, among the ICRA-rated entities, there have been no downgrades during H1 FY2021 considering the impact of Covid-19, although some entities were placed on Negative Watch/Negative Outlook.**
- Within the specialty chemical segment, however, segments which are largely catering to end-user industries like construction and auto are more likely to be adversely impacted, compared to companies which are catering to sectors like pharma, FMCG, personal care and food segments. Further, companies catering to auto and construction are also expected to witness a gradual recovery in demand with improvement in industry prospects during H2 FY2021. Companies with low leverage and diversified product and customer base are better placed to withstand the downturn.
- The medium to long term outlook remains favourable for the specialty chemical segment, aided by growth prospects in the domestic market as well as robust demand from the export segment.

TABLE 1: Specialty chemicals sub-segment outlook

Segment	Key End User Segment	Near Term Financial Performance Outlook	Credit Outlook
Agro-chemicals	Agriculture Sector	Positive	Stable
Dyes & Pigments	Construction, Textile	Negative	Stable
Flavours and Fragrances	F&B, Home Care and Personal Care	Stable	Stable
Surfactants	Cleaning Products, Personal Care	Positive	Stable
Construction Chemicals	Real Estate and Infrastructure	Negative	Stable
Fluorochemicals	Aluminum Industry, Refrigerants, Pharma and Specialty Fluorochemicals	Negative for Refrigerant and Metals; Stable/Positive for others	Stable

The segment wise outlook is given below

- **Agrochemicals -** With nearly 70% of the total pesticides available in India focused on paddy and cotton crops, and these crops witnessing 7.5% YoY and 1.9% YoY growth in sowing levels respectively, the agrochemical sector has witnessed robust growth in the sales volume in Q1 FY2021. Product sales have witnessed growth across the product categories i.e. herbicides, insecticides, fungicides and plant growth regulators. The export market, however, has witnessed some headwinds, given the Covid-19-led restrictions on movement of men and material. Going forward, the demand for agrochemicals is expected to remain healthy in the domestic as well as export markets, given the favourable agricultural outlook globally and the support being provided by Governments across the globe to agricultural activities to ensure food security. In the domestic market, healthy reservoir levels and a good moisture level, supported by expectations of higher farm incomes and healthy minimum support prices should enable a better offtake in H2 FY2021 as well.
- **Dyes and Pigments** - The near-term demand for dyes and pigments will be impacted due to the expected slowdown in construction and textile sector in the wake of the Covid-19 pandemic. However, in the medium to long term the demand prospects remain favourable, driven by recovery in construction and the textile segment. However, the segment will remain susceptible to increased environmental regulations and the manufacturers will need to follow strong environmental standards and compliances.
- **Flavours and Fragrances -** Despite the current slowdown in demand due to the pandemic, the outlook for the Flavours and Fragrances segment remains somewhat resilient, owing to its use in FMCG, pharma and food and beverage industries, which have been less impacted by the pandemic. However, the personal care and cosmetics segment has been more severely impacted. Nevertheless, margins have remained healthy, owing to niche products and the advantage of raw material availability in the country. Notwithstanding the dip in revenues and margins in FY2021 due to the pandemic, over the long term the outlook for the flavours and fragrances segment remains healthy, owing to the growth in per capita income, increased production of processed foods, increasing penetration of FMCG products in rural areas, increasing premiumisation in consumption etc. Additionally, due to the advantage of raw material availability such as spices, mint etc. the margins of the incumbents are expected to remain healthy.
- **Surfactants -** Despite some impact on the segment in Q1 FY2021 due to the disruption caused by the lockdown, the domestic demand trend has witnessed improvement for the home and personal care hygiene segment due to increased sanitisation needs during the pandemic, which should partly mitigate any adverse impact on demand from other segments for surfactant. This heightened demand for cleaning products is expected to continue at least in the near term, although there may be some rationalisation in the medium term. Further, companies with diversified geographical presence are also expected to benefit from robust export demand for cleaning products. In the medium to long term, the demand outlook remains favourable aided by growth in demand for the Personal and Home Care segment as well for the use of surfactants in the niche sectors.
- **Construction chemicals -** The construction chemical sector is expected to witness subdued domestic demand in the near term due to the impact of Covid-19 on the construction sector. However, the medium to long term outlook remains favourable, driven by expected infrastructure growth, increasing urbanisation, low consumption of construction chemicals in construction at present and increasing adoption of global standards. The Government's plans of infrastructure investment of ~Rs. 111 trillion over a five-year period (FY2020-FY2025) under the national infrastructure pipeline, will be favourable for the sector. However, due to the impact of Covid-19, the first two years of NIP are likely to remain below target.
- **Fluoro-chemicals -** With high share of domestic demand for fluorochemicals driven by the refrigerant segment, the near-term outlook is subdued due to muted outlook for white goods and the refrigeration segment. Further, domestic aluminium demand growth is also expected to decline by 10% in FY2021, which will also impact demand for fluorochemicals from this sector. However, the demand from sectors like pharma should remain stable or witness modest growth in the near term. Further, companies with diversified presence in specialty fluorochemicals or CRAMs for the pharma segment will be able to buck the downturn. In the medium to long term, however, the demand prospects for fluorochemical segment remains healthy, driven by growing refrigeration and air conditioning demand in India, expected recovery in the auto sector and growth in demand from other segments. Further, with the recent Government ban on import of ACs with refrigerants, there will be additional opportunities for domestic manufacturers in the medium term. However, companies with presence mainly in the HCFC segment will have to shift to newer products, in line with the phasing out of HCFCs.

TABLE 2: Key rating actions since end March 2020 for ICRA rated specialty chemical cos

Sr no	Company name	Previous rating	Current Rating	Date	Remarks
1	Acme Chem Limited	A/stable/A1	A/negative/A1	Jun-20	Outlook revised considering near term adverse impact of Covid-19
2	Dhanuka Agritech Limited	AA-/Negative Watch/A1+	AA-/Positive/A1+	Sep-20	Removed from Negative Watch and outlook revised to Positive, considering healthy performance in FY20 and Q1 FY21
3	Ganesh Polycem Limited	A/stable/A1	A+/stable/A1	Jul-20	Ratings upgraded based on comfort from parent -Aarti Industries Limited
4	Himadri Speciality Chemical Limited	AA-/stable/A1+	AA-/Negative/A1+	Oct-20	Outlook revised considering near term adverse impact of Covid-19, due to company's exposure to aluminium, graphite and automobile sector
5	Hy-Gro Chemicals Pharmtek Pvt. Ltd	BBB/stable/A3+	BBB/negative/A3+	Jul-20	Outlook revised based on healthy performance and expected improvement driven by demand from Pharma Sector
6	Intech Organics Limited	BBB-/stable/A3	BBB+/stable/A3+	Aug-20	Rating upgraded since company's product is used for fumigation and has witnessed increased demand due to Covid-19
7	Merchem Limited	-	A/negative/A1	Jun-20	Fresh rating assigned and consolidated view taken with holding company Acme Chem Limited
8	Neelikon Food Dyes and Chemicals Limited	A+/stable/A1	A+/negative/A1	Mar-20	Outlook revised due to disruption in sales and supplies to China due to Covid-19
9	Premier Explosives Limited	A-/stable/A2+	A-/negative/A2+	Jul-20	Outlook revised due to impact of Covid-19 on operations
10	STP Limited	BBB/stable/A3+	AA(CE)/stable/A1+(CE)	Sep-20	Upgraded based on corporate guarantee provided by Berger Paints
11	Vasant Chemicals Pvt. Ltd	BBB-/positive/A3	BBB/positive/A3+	Sep-20	Upgraded due to improved performance in FY20 and expected high margin in FY21 despite Covid19

INDUSTRY HIGHLIGHTS

- The Indian specialty chemical sector is estimated to be around $32 billion. The sector comprises value-added products and enjoys relatively higher margin compared to basic and petrochemical segment. Due to the niche nature of several products, this part of the domestic chemical industry comprises several sub segments, each of which have their own demand-supply dynamics and risk profile. These products are derived from basic and petro-chemicals and tend to be low volume products and can be broadly classified based on their end-use or function. In this note, ICRA has analysed six sub segments, including – Agrochemicals, Dyes and Pigments, Flavours and Fragrances, Surfactants, Construction Chemicals and Fluoro Chemicals.
- The domestic specialty chemical market has witnessed healthy growth at a CAGR of ~12% in the last five years. The market, however, remains fragmented with the presence of large unorganised players. However, in the last few years there has been scaling up of some of the domestic players and there is also a growing presence of global MNCs in certain segments, who have set up manufacturing units in India or have acquired domestic companies. The unorganised presence in more in sub segments with lower level of R&D requirement and catering to unorganised or retail customers. However, ICRA expects that over time increased formalisation will happen in the segment as domestic players scale up and invest in R&D and the nature of demand also changes with growing preference for better performance chemicals, adoption of global best practices etc. There will also be increased consolidation in the segment with large domestic players acquiring regional players and the MNCs acquiring larger domestic players.
- India is also a major exporter of specialty chemicals and is a net exporter in this segment catering to supply chain of global players. However, on the feedstock front the industry is still dependent on imported raw material for many chemicals. Indian specialty chemical exports are driven by the availability of skilled and cheap labour and low-cost manufacturing capabilities. On the other hand, the domestic demand drivers also remain favourable with low per capital specialty chemical consumption, growing disposable income, increasing urbanisation and changes in consumption trends. The domestic demand is likely to see faster growth in the medium to long term in segments like personal care, cleaning solutions, and construction chemicals.
- In the last few years the domestic industry has focused on scaling up and increasing R&D. Further, contract research and manufacturing services (CRAMs) have also emerged as an attractive option, with global players looking at outsourcing production to suppliers who can provide consistent quality and stable supply. Global majors like BASF, Dupont, Syngenta etc. have adopted this model and have successfully developed suppliers in India. While India has been a growing player in the segment, China has been a global leader in production of specialty chemicals. Nonetheless, due to factors like closure of the facilities in the last few years following increased environmental regulations, the US-China trade wars and growing geo political issues leading to global players looking at supply chain diversification - Indian specialty chemical manufacturers may benefit from the trend.
- In the current fiscal, however, the specialty chemical sector has also witnessed the impact of the Covid-19 pandemic. While, during the earlier period of lockdown, there was disruption in manufacturing and logistics, gradually there has been a recovery in production trends and the impact of subdued domestic demand in some sub segments has been offset by high export demand. Nonetheless, there are still issues of labour availability and specialty chemicals mainly catering to the construction, textile and automotive sector have been adversely impacted. The segments catering to pharma, FMCG and personal care have been less impacted or have witnessed growth.

Specialty chemical sector is well placed to benefit from "China+1" strategy of global players

In the last two decades, China has emerged as the global leader in chemical manufacturing accounting for ~36% of global production. This has been driven by changes in global supply chain, with MNCs increasingly shifting manufacturing to countries like China where the total cost of manufacturing was much more competitive. The competitiveness of China was driven by its push for large scale manufacturing, availability of skilled labour and support infrastructure through chemical clusters. However, due to the geo political events and issues like US-China trade war, there is increasing focus on diversification of supply chain and having additional manufacturing locations. Further, in the last few years there has also been increased environmental scrutiny of chemical sector in China, which had led to closure of several facilities, disrupting the supply chains leading to spike in prices ofseveral chemical segments. Further, there has also been tightening of financial availability for the sector, which has also impacted the capex in Chemical sector in China in the last few years. Finally, with the outbreak of the Covid-19 pandemic, many companies are actively looking for changes in supply chain and reducing dependence on China to reduce production costs and have better long term stability of supply chains.

Key reasons for "China +1 "

1. **Increased environmental regulations**
2. **Tighter financing norms**
3. **Geo-political issues and trade wars**
4. **Need for diversification post Covid-19**

India could be a beneficiary of this macro trend, especially in the specialty chemical segment. India has several advantages in terms of:

(a) Availability of skilled labour and labor cost being lower than China.
(b) Established relationship with global players and track record in the specialty chemical segment – Specialty chemicals account for nearly 50% of total chemical exports from India, although the share of world wide chemical export remains modest. Within the specialty chemical segment, agrochemicals, dyes and pigments and APIs for pharma sector are some of the segments where India has an established track record. The companies in these segments have scaled up in the last few years and also invested in R&D. However, India has good potential in export of other specialty segments like flavours and fragrances, food chemicals, specialized fluorochemicals etc.
(c) Favorable policies with regards to intellectual property rights – It is important to have strong IPR policy to attract global players

Further, India's domestic demand is also expected to witness growth in the medium to long term for specialty chemicals, which also makes it attractive for global players to have local manufacturing. Further, the GOI's "Atmanirbhar" push is also expected to provide benefits to the sector in terms of rationalization of duty structure and other incentives to establish feedstock manufacturing units. In the past, the domestic chemical sector was partly impacted by unfavorable duties on imports and FTAs with South East Asian countries, however some of these concerns are being addressed by Gov't by imposing non tariff barriers and duty protection measures like ADD and safeguard duties. India also has huge potential for Contract Research and Manufacturing Services (CRAMs) in specialty chemical segment, especially for catering to agrochemicals and pharmaceutical sector. There are already few domestic players who are engaged in CRAMs for global players, who have received multi year orders.

While, India is well placed to benefit from the expected changes in global supply chain trends, there are certain constraints which needs to be addressed to be able to fully leverage the potential.

Gov't had planned four PCPIR in India at Dahej(Gujarat), Vizag (AP), Paradip (Orissa) and Cuddalore (TN). However, the projects have not taken off as planned due to stiff opposition by locals and other organisations for various reasons including environmental concern, land acquisition issues and other factors . This has led to Gov't of Tamil Nadu announcing scrapping of project. Of the panned regions, only Dahej has seen meaningful investments.

1. **Dependence on imported feedstock -** India is still dependent on imported feedstock supply as domestic petrochemical production is focused towards bulk polymers. In order to ensure better feedstock supply, Gov't should take steps to ensure faster implementation of projects like PCPIR (Petroleum, Chemicals and Petrochemicals Investment Regions) and provide incentives and favorable policies to build up domestic intermediate capacities. Gov't is looking at proposals for tax incentives for greenfield and brownfield projects and may also amend PCPIR policy to extend the incentives.

2. **Lack of scale -** Further, Indian companies lack scale with only few players having scaled up significantly in the last few years. In order to move up the value chain in the specialty chemical segment, it will be imperative for domestic companies to scale up and increase investment in R&D. There have also been instances of MNCs acquiring domestic companies and such consolidation is expected to accelerate, leading to increasing formalization of the sector.

3. **Better environmental and safety policy and compliance -** Finally, India also needs to have a more robust environmental policies to address ESG concerns related to chemical projects. As several projects including the PCPIR have faced stiff resistance from locals and environmental organization. It will be necessary for Gov't to follow a policy which ensures strict compliance in spirit and ensure public confidence, as recent accidents (LG Polymer's accident in Vizag in May 2020) will result in further opposition to projects

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