

Chemicals

Weak industry conditions improve in the second half of the year

January 9, 2024

This report does not constitute a rating action.



What's changed?

Petrochemicals will remain in a cyclical trough longer than anticipated. While we expected the industry to improve in early 2024, supply and demand will remain challenged through 2024.

Recovery in the sector pushes into mid-2024. Headwinds like macro uncertainty, the China slowdown, weak demand, and pricing pressure, will persist but lessen in 2024.

Destocking bites deeper. Chemical buyers relied on their inventory to supplant purchases longer than we anticipated. As a result, chemical volumes sold last year were below expectations.

What are the key assumptions for 2024?

Global economy growth will slow slightly. We forecast the global GDP will grow 2.8% compared to 3.3% in 2023, driven by slower growth in the U.S. and Asia-Pacific (APAC).

Profitability to drag in 2024; cost competitiveness differs by region. We expect U.S. producers to trail Middle Eastern counterparts but perform better than those in Europe and APAC.

Broadly stable fertilizer prices. With affordability normalized, limited capacity additions, and reduced Chinese exports, fertilizer prices should remain broadly stable in 2024.

What are the key risks around the baseline?

Demand risk. Poor growth could stall or reverse a recovery in credit metrics in 2024, while destocking and recessionary conditions could hurt demand in key markets.

Capital market access. Rising rates could make access to debt markets and affordability difficult for speculative-grade credits, although the maturity profile in 2024 looks relatively light.

A bearish outlook for Europe petrochemicals extends past 2024. This depends on capacity rationalization of older, less efficient plants to rebalance the market and help competitiveness.

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Ratings Trends: Chemicals

Chart 1
Ratings distribution

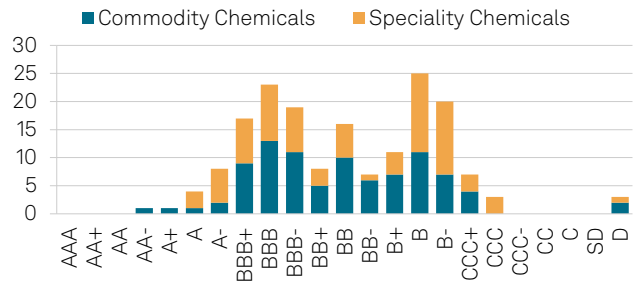


Chart 2
Ratings distribution by region

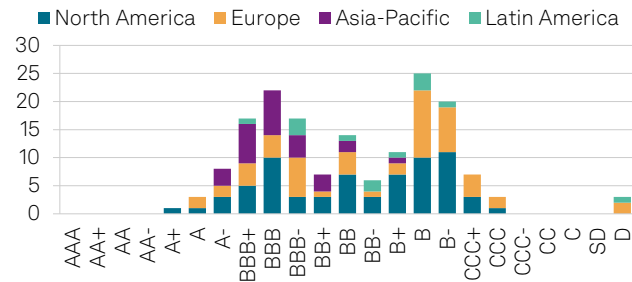


Chart 3
Ratings outlooks

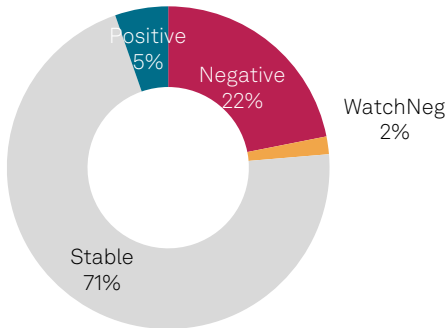


Chart 4
Ratings outlooks by region

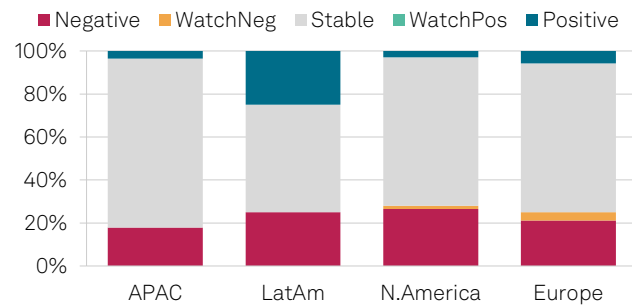


Chart 5
Ratings outlook net bias

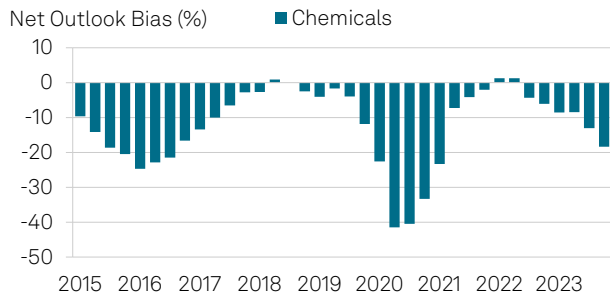
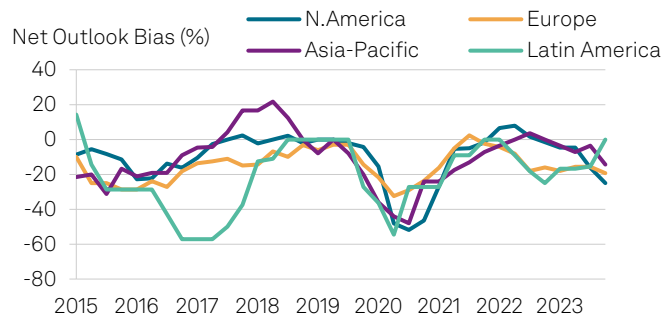


Chart 6
Ratings net outlook bias by region



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook

Ratings trends and outlook

Nearly a quarter of our ratings outlooks are negative and only 5% are positive. The resulting net negative outlook bias at slightly below 20% is a post-pandemic peak. Median credit ratios, including total debt to EBITDA and funds from operations (FFO) to total debt weakened in 2023 relative to the previous year. We believe median ratios will strengthen slightly next year, driven by our assumption for modest demand growth and improved EBITDA and margins.

This growth assumption applies broadly across the sector, including key subsectors such as petrochemicals, agriculture, and many specialty chemicals, but we assume growth will be uneven across individual companies and regions. Additionally, most growth will likely occur in the second half of 2024, when we expect there will be a less pronounced impact from disruptive factors such as destocking.

Our negative outlooks speak to the risks to credit quality if this base case for growth does not play out or if supply additions in sectors such as petrochemicals are more disruptive than we expect.

Main assumptions about 2024 and beyond

1. Petrochemicals in a cyclical trough through 2024, but slow improvement to start in 2025.

Destocking, some challenged key end markets (such as housing), and slower-than-expected growth in China has hampered demand in the petrochemicals industry. Additionally, the ramp-up of new capacity and limited permanent capacity closures to date have led to oversupplied industry conditions. We expect these challenges, which are exacerbating already weak supply and demand fundamentals, to continue in 2024, delaying a recovery in the sector.

2. Overall global economic growth forecasts are slightly slower than 2023.

Strong labor markets and fiscal tailwinds drive the upside, whereas uncertainties about the lagged transmission of cumulative rate hikes since early 2022 are driving the downside. In the U.S., we forecast a growth rate of 1.5% in 2024, with the eurozone expected to grow slightly at 0.8%. In APAC, while headwinds remain, we forecast a healthy growth rate of 4.4%. Higher interest rates will affect consumer spending and lead to overall slower economic growth. However, we believe many companies' revenue and earnings will improve as destocking in most sectors begin to benefit issuers through strengthened volumes. We expect inflationary pressures will ebb somewhat in 2024, allowing margins to slightly improve.

3. Improved affordability and broadly balanced supply and demand will stabilize fertilizer prices in 2024.

This follows a period of marked correction in fertilizer prices in the second half of 2022 and first half of 2023 after a structural supply shortfall sparked by the Russia-Ukraine war caused unsustainably high fertilizer prices. This eroded farmers' affordability and caused demand destruction.

The petrochemical sector will remain in a cyclical trough. Our base case assumes continuing challenges in supply and demand fundamentals in the olefins and polyolefins chains through 2024. Large capacity additions (primarily in China and the U.S. Gulf Coast) began in 2021 and we expect them to continue to ramp up in 2024. This combined with a general macroeconomic malaise is likely to leave earnings depressed in 2024 (albeit with some gradual improvement from trough 2023 levels).

We expect a more tangible improvement in earnings starting in 2025, given more-favorable supply/demand dynamics. Any sustained improvement in profitability would likely be driven by a rebound in demand from China and permanent capacity closures to help ease oversupply conditions. Our base case assumes natural-gas based U.S. producers will remain toward the lower end of the global cost curve, trailing Middle Eastern producers but still advantaged compared with more naphtha-based petrochemical companies in Europe and Asia.

The U.S. economy is headed for a soft landing. After outperforming expectations so far in 2023, led by spending on consumer services, the U.S. economy appears to be headed for a soft landing in 2024, growing at 1.5% compared with 2.4% in 2023. Sharp monetary policy tightening during the past year and a half will have an effect in the coming year, when higher costs of capital will lower business capital expenditures and hiring. Consumer spending is poised to be more in line with real income growth as excess cumulative savings dwindles. We continue to forecast core inflation (excluding volatile energy and food prices) will fall closer to levels consistent with the Federal Reserve's target of 2.0% by the middle of next year.

A soft eurozone economy remains likely over the near term, with real incomes set to rise because of disinflation and resilient labor markets. The eurozone GDP forecast is broadly unchanged at 0.8% in 2024 versus 0.6% in 2023. Production has suffered from high energy prices and destocking (manufacturing is in recession). Fiscal policy is no longer expansionary (although there are differences from country to country), and the passthrough of policy rate hikes has been relatively swift. It's likely the eurozone economy will bottom out in the first quarter of 2024 or see a shallow recession, but once inflation eases significantly enough to prompt the European Central Bank (ECB) to lower its policy rates, we believe the economy will rebound. The pattern of the economic slowdown, which we expect will continue over the first half of 2024, likely changes as the strong momentum in services abates with the end of the manufacturing recession possibly in sight.

In APAC the overall economic growth rate will slow slightly, to a still-healthy 4.4% from 4.7%. Emerging market economies such as India, Indonesia, Malaysia, and the Philippines are posting the strongest growth. With core inflation continuing to ease, the region's central banks are unlikely to tighten monetary policies again but will exhibit no meaningful declines for at least the next six months. China's property weakness continues to weigh on the economy, but growth momentum has slightly improved because of policy support. We predict the country's GDP growth will slow to 4.6% in 2024 from 5.4% in 2023.

The structural cost disadvantage of Europe-based nitrogen producers versus those based in the U.S. or the Middle East will persist. We also expect crop nutrition deliveries will remain broadly stable despite increased application rates and the fact that affordability for farmers has improved from the low 2022 levels. This is because we expect buyers will continue to display cautious behavior in an environment of declining fertilizer prices and--in certain regions--will build into their purchasing decisions the risk of drought from El Nino. As a result, fertilizer buying may be delayed closer to the application season, taking some purchases from 2023 into 2024.

In potash, given improved fertilizer affordability and as farmers prioritize nitrogen and phosphate applications, we anticipate healthy demand and the ongoing structural supply deficit to

somewhat support prices. In phosphate, we believe supportive grain fundamentals, China export limitations, low inventories in India, and higher acreage in Brazil will support demand and prices.

Credit metrics and financial policy

Overall, issuers across the sector have lowered earnings expectations at the midpoint of 2023, citing weak end market demand (or in some cases channel destocking overshadowing a relatively strong end market) and competitive pressures affecting pricing. Generally, we expect earnings to remain pressured going into the first half of 2024, with companies exposed to less-discretionary end markets and with pricing power to fare better than the industry average.

We expect credit metrics to improve in the second half of 2024, largely a result of inventory destocking throughout many of the chemical sectors. Destocking has taken longer than we expected as GDP growth in China and Europe is slower and the U.S. consumer base has allocated spending power more toward services than manufacturing. Benefitting from a strong 2022, many companies' balance sheets, especially those in the investment-grade space, are in sufficient shape to weather trough industry conditions, particularly in the petrochemical space.

The portfolios outlook is largely stable at 72%. However, this has trended lower due to some negative rating actions in the deep speculative-grade space and in Europe, where high energy costs, destocking, and overall weak economic conditions have led to underperformance and low plant utilization rates for some issuers.

Key risks or opportunities around the baseline

1. Lower demand as customers dip into their inventories and hold off/reduce purchases.

We believe customers will run down inventory levels and increase their purchases of chemicals in 2024. Although demand will increase, we do not expect demand to strengthen as much as it did after the pandemic. The risk to our base case is that customers could delay increasing purchases for longer than we expect or a more fundamental demand weakness could set in.

2. Capital market access concerns remain for deep speculative-grade issuers.

Most chemical issuers proactively refinanced debt maturing in 2024, albeit at higher interest costs. However, for smaller deep speculative-grade issuers, access to capital may prove daunting.

3. Headwinds for European producers extend well beyond 2024.

This is due to higher cost positions and competitive pressures, prompting decisions to rationalize production footprints.

Demand recovery is key. After a choppy year for demand, we expect a less-stormy back half of 2024, with modest demand growth overall. Overall, we assume demand will be more predictable absent the vagaries of destocking or an unexpected China slowdown that characterized 2023. This relatively steady growth is an important credit support, especially at lower rated companies, not only for earnings improvement but also for reducing working capital and improving operating cash flow generation.

Speculative-grade issuers' ability to refinance maturities is an important factor. Most chemical companies were proactive in managing their debt maturities and took advantage of lower rates and extended their overall debt maturities. Even speculative-grade issuers, which are more exposed to increases in interest rates and scrutinizing capital markets during industry troughs, have relatively light debt maturity profiles in 2024.

However, given the current unfavorable operating climate, there are growing refinancing risks. For speculative-grade issuers, debt maturities meaningfully ramp up during 2025 and beyond. If interest rates stay high and industry conditions in some chemical sectors remain weak, speculative-grade issuers may struggle to access capital. Indeed, nearly half of the debt maturing during 2024-2026 is held by issuers rated 'B-' or below. Even if an issuer can refinance, the transaction could weaken its cash flow metrics.

Headwinds for petrochemical producers in Europe are extending well beyond 2024. Like global peers, petrochemical producers in Europe face industry overcapacity and weak end-market demand. In Europe, the situation is exacerbated by elevated energy prices; limited access to low-price gas feedstock in contrast to U.S. or Middle East producers; competitive pressures; and rising carbon dioxide costs. These result in higher production costs in the region and highlighted competitive disadvantage of European producers. We expect the gap in margins to industry peers with production footprints more focused on the U.S. or Middle East will remain given continued higher energy costs.

Capacity utilization in the EU27 chemical industry declined once more in the third quarter of 2023, according to the European Chemical Industry Council, and was at 74.1% versus the normal range of 82%-85%, notwithstanding numerous production footprint rationalizations and ongoing efficiency measures. In addition, temporary and permanent shutdown of older, inefficient, and uncompetitive sites in Europe continue amid sustained high energy, raw material, and labor costs, and competitive pressures. According to Chemical Week, more steps to remove surplus capacity in Europe are expected as firms look to shut older, less efficient plants. The success of these efforts to improve competitiveness will be key to the credit quality in 2024 and beyond.

Related Research

- [Financial And Refinancing Risks Run High For Low Speculative-Grade U.S. Chemical Producers](#), Oct. 31, 2023
- [Credit FAQ: Europe's Chemical Sector Feels The Chill In A Cooling Economy](#), Sep. 13, 2023
- [Sector Review: Recovery Won't Be Quick For Asia Chemicals](#), Jul. 20, 2023
- [Industry Top Trends Update Europe: Chemicals](#), Jul. 18, 2023
- [Industry Top Trends Update Asia-Pacific: Chemicals](#), Jul. 18, 2023
- [Industry Top Trends Update North America: Chemicals](#), Jul. 18, 2023

Industry Forecasts: Chemicals

Chart 7
Revenue growth (local currency)

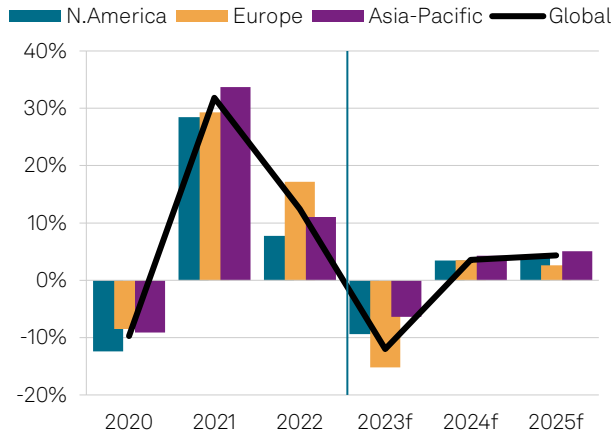


Chart 8
EBITDA margin (adjusted)

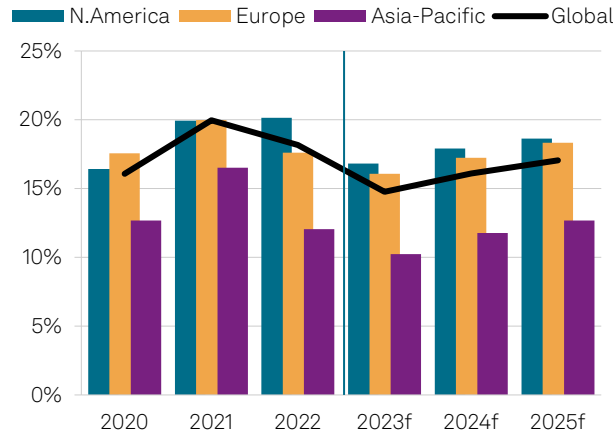


Chart 9
Debt / EBITDA (median, adjusted)

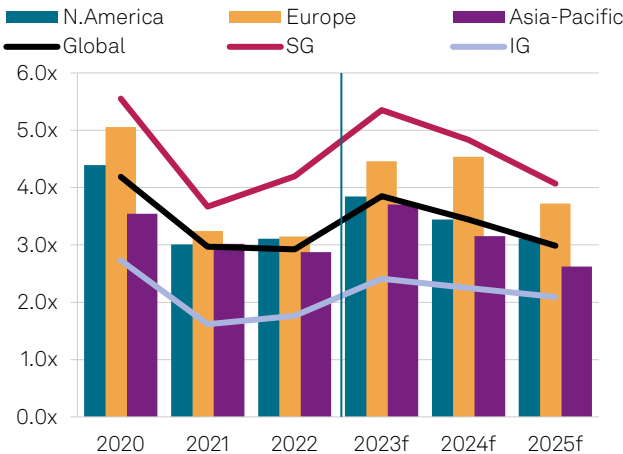
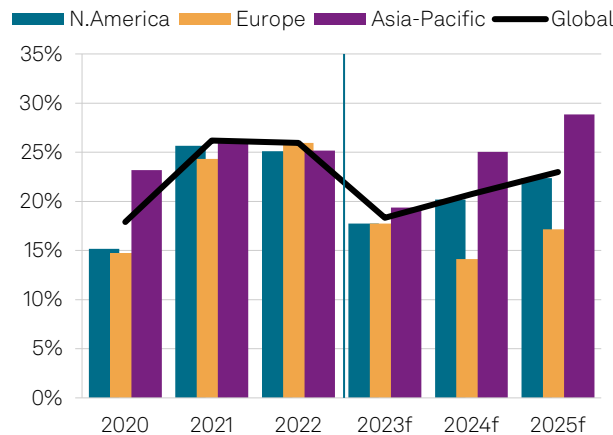


Chart 10
FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = forecast.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Chemicals

Chart 11

Cash flow and primary uses

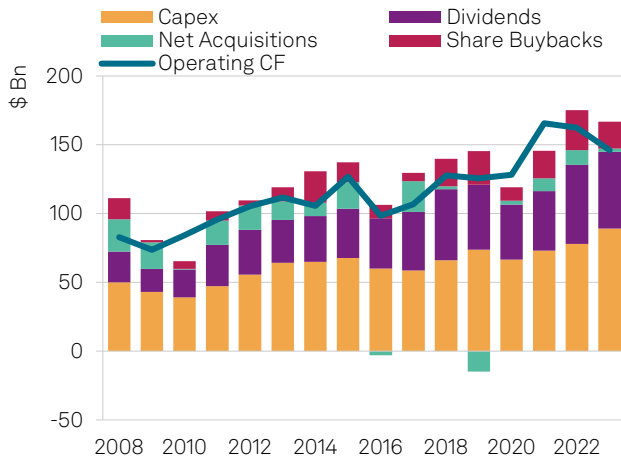


Chart 12

Return on capital employed

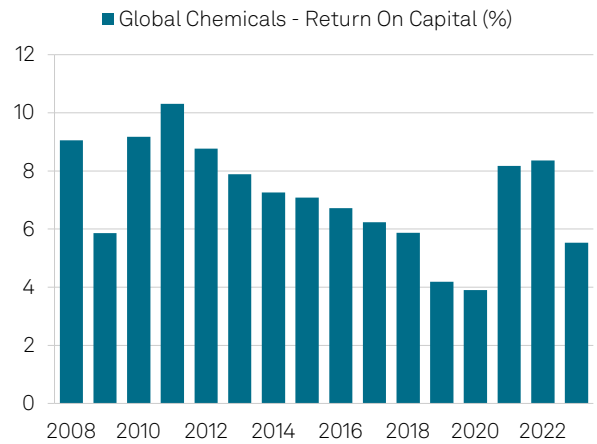


Chart 13

Fixed- versus variable-rate exposure

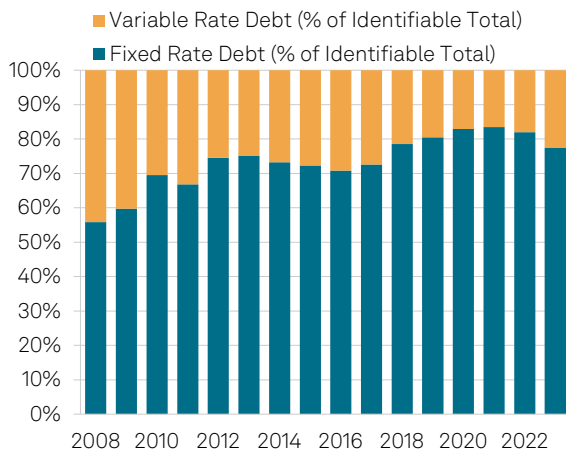


Chart 14

Long-term debt term structure

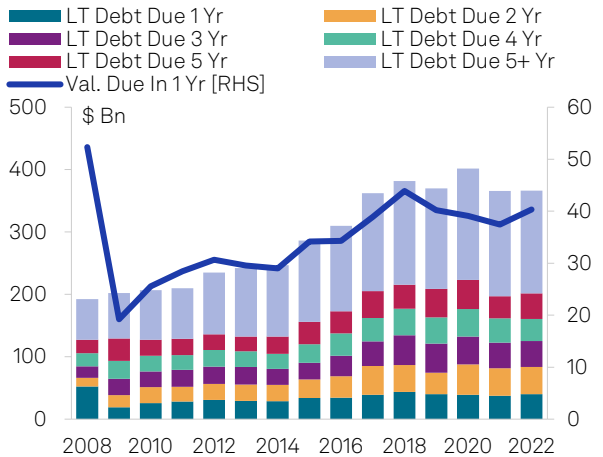


Chart 15

Cash and equivalents / Total assets

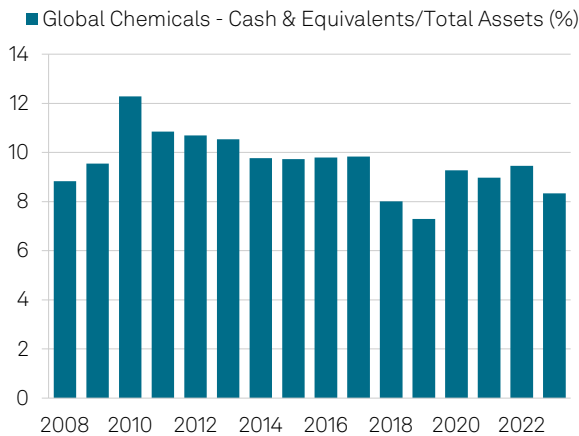
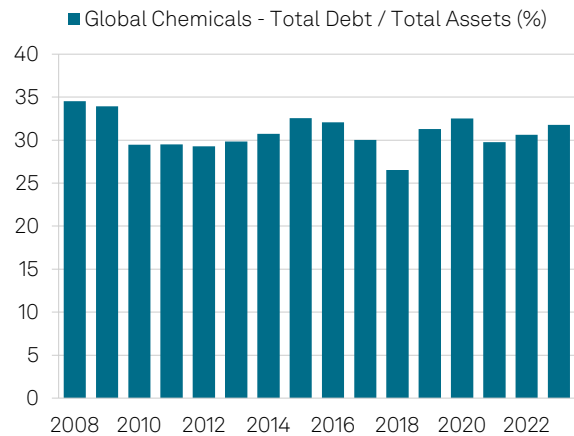


Chart 16

Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2023) figures use the last 12 months' data.

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