2006

Painting a Picture of the Coming Year for Coatings

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As we approach the end of 2005, it is natural to look ahead and wonder what the New Year will bring. How will the devastation caused by Hurricanes Katrina and Rita impact the coatings market? Will the reconstruction effort balance out any negative effects? Rising energy and raw material costs will again be a key part of the story, as will the (in)ability to pass on price increases. Consolidation within the paint and coatings industry will continue, largely impacting small regional players. The trend toward ever stricter regulatory requirements with regard to VOCs and HAPs will also be part of the story again in 2006. Cost management and maximization of productivity and efficiency will be the keys to success in the coming year.

In the United States, the volume of coatings sales in 2004 totaled 1.6 billion gallons. In 2005, an increase of 2.3% in volume is expected, but for 2006 that growth rate is predicted to fall to 1.8%, according to Dr. Thomas Kevin Swift, senior director–Economics & Statistics with the American Chemistry Council. This projected decrease in the growth rate reflects the expected slow down in the growth of the gross domestic product (GDP) for the U.S., which has dropped from 4.2% in 2004 to 3.5% in 2005, and will see a further slide to 3.0% in 2006.

The largest end-use for coatings is in construction and housing, which accounts for 56% of sales. The next largest applications are furniture (7%) and automotive (6%), according to Dr. Swift. All segments of the coatings market--architectural, OEM, and industrial maintenance—will be affected by a slowing economy and increasing fuel and raw material prices in 2006. "However, recent assessments of the impact of Hurricanes Katrina and Rita indicate that the economy will weather this storm better than originally expected," notes Dr. Swift, which is good news for the coatings industry.

Despite the slight reduction in volume of sales, North America remains a growth region for paint and coatings. Demand for coatings is still strong because of continued population growth. Developing regions such as Asia

Pacific and Eastern Europe are growing even more rapidly, with demand for paint and coatings expected to remain strong for some time. The coatings market in areas such as Japan and Western Europe, however, is stagnant at best. The U.S. economy outlook remains uncertain. "A slowing economy in the U.S. could cause a slow down in the global market too," says Michael D. Brown, vice president of The ChemQuest Group, a management consulting firm located in Cincinnati, OH. If that occurs, there will be a decrease in demand for coatings across all sectors.

Dealing with rising energy—both oil and natural gas—and raw material costs will continue to be a major issue for paint and coatings producers in 2006. "Throughout 2005, coatings manufacturers have been working to push price increases through the supply chain. They have succeeded to some extent, but prices will have to come up even further if margins are to be maintained," Mr. Brown adds.

It can be tricky, however, to introduce price increases, particularly for smaller, regional paint companies. "In regional areas, often the first company to raise prices risks the loss of business to competitors who are waiting to let someone else take the plunge," explains William A. Hansen, a grass roots consultant in the industrial maintenance sector. "Deciding when to pass on price increases is critical, because taking action impacts the established relationships a company has with its customers." For this reason it is essential to diversify into the higher end technical/specialty products where R&D, service, and technical support are as important as pricing.

Nevertheless, it is a well accepted notion that in 2006 prices for coatings will be higher than they are today. According to Mr. Brown, much of the coatings industry experienced commodity-like pricing for many years, which was associated with a drop in earnings. "The higher prices expected in 2006 will enable coatings manufacturers to achieve improved margins, and, even with a slowed economy, a potentially substantial increase in profits," he notes. On another positive note, it appears that constraints on resin supply seem to have resolved themselves for the most part and should not be an issue in 2006.

Compliance with environmental regulations is another issue that will carry over from this year to the next. "Formulators are all trying to get solvent out of paint and are introducing high-solids or waterborne coatings in order to comply with VOC and HAP regulations," says Steven Nerlfi, a consultant with Kusumgar, Nerlfi & Growney. "Providing equal or better performance while meeting these requirments, and doing so cost effectively, remains a challenge for the paint industry," he adds. He also notes that more and more individual states are passing regulations that are stricter than the federal EPA standards, which will only add complexity to the situation.

In addition to further price increases and environmental compliance issues, the higher level of mergers and acquistions activity experienced in 2005 is anticipated to continue in 2006. As in 2005, too, private equity will be responsible for most of the transactions, according to Mr. Brown. "There is unlikely to be much portfolio swapping among coatings companies. Each entity has its own personality and strategy. Maintaining credibility with investors becomes difficult if a company alters its course in any significant way," he explains. The larger paint companies, however, will look to acquire more regional players that are struggling to survive, according to Mr. Nerlfi.

Globalization of the paint and coatings industry is also expected to proceed in 2006. As OEM production has shifted to low cost regions of the world, coatings manufacturers and their suppliers have followed. Further announcements of new production, R&D, and distribution facilities are expected in the New Year.

Just as different regions of the world will have different growth rates for coatings, the market for different types of coatings will also vary within each region. In the U.S., architectural coatings should continue to per-

form well, as the housing market is expected to remain robust. "In 2005, we have had a record year with the number of housing starts and resales," says Dr. Swift. "While there may be a slight cooling off next year, the government is not expecting the bubble to burst." Around $20 billion of chemicals are used in the housing and construction market, and 6.7 metric tons of that material is polymers.

The resale level of homes is a good indicator of the health of the architectural coatings market, according to Robert J. Koch, president of Robert J. Koch Associates and a joint venture partner with The ChemQuest Group. It is expected to remain high in 2006. Mr. Koch also does not believe rising prices will keep people from painting their homes. "A person's house is his or her biggest asset. Maintenance of their investment will remain a priority, and painting is a necessary aspect of the upkeep of a home," he says.

As raw material prices rise further, Mr. Koch does anticipate some reformulation on the part of paint companies as they seek alternative, less costly ingredients. Natural products that are not derived from petrochemicals may be used as substitutes, although he questions the likelihood of finding natural materials that can provide the same level of performance offered by traditional compounds.

The architectural market will also continue to see large "Big Box" stores such as Home Depot and Lowe's maintain their dominance of the do-it-yourself (DIY) segment as they continue to add new stores. The contract segment of the architectural market, which currently accounts for more than 65% of sales, will experience slight growth as has been the case in 2005. Paint stores themselves will grow through further acquisition.

Hurricanes Katrina and Rita will impact the architectural coatings market in two ways. First, the closure of the DuPont titanium dioxide (TiO_2) plant in Mississippi will result in a potential shortage of the material. DuPont is the largest producer of TiO_2 and this plant is its largest facility, supplying a global customer base. "I expect the market will be impacted by this plant closure for the next several months, including the first few months of 2006," says Mr. Brown. He does, however, predict that the situation will be resolved by the second quarter of next year. Second, on the positive side, reconstruction in the damaged areas will lead to strong demand for paint and coatings. Although there will be a lag of six months or so, the rebuilding efforts could be a substantial factor for the architectural market.

The industrial maintenance and OEM sectors will not experience the same growth rates as the architectural coatings market. Still, the industrial maintenance coatings segment, which parallels capital investment, showed growth in 2005, as there was some increase in capital spending to increase petrochemical capacity and to improve the public infrastructure, according to Mr. Brown. This activity is expected to continue into 2006. In addition, many companies will be rebuilding and repairing facilities in the areas stricken by hurricanes and this added demand will contribute to growth in the industrial maintenance market. Mr. Brown predicts that concrete results will be noticeable by the end of the third quarter of next year.

Success in the industrial maintenance market can be aided by following a strategy of diversification, according to Mr. Hansen. "Companies that look to expand into more segments of the market can increase sales in areas where they are already active by selling into other end-use applications. They can achieve a high return because there is little added investment necessary for pushing into a new market," he says. "Diversification expands their sales and provides them with a buffer when certain aspects of the market slow down." Mr. Hansen notes that this strategy is very effective for companies in the architectural, commercial, and OEM coatings sectors, because they can readily find potential customers in the industrial maintenance market within their existing client base, or at least within their territory.

In North America, OEM coatings, which include those for automotive, furniture, appliances, and other such applications, are not expected to experience much growth in 2006. U.S. automakers, since 9/11, have maintained target sales of light duty vehicles at 16-17 million units. This level of sales is not expected to change, according to Dr. Swift. Furniture makers face tough competition from overseas suppliers. Appliance manufacturers have experienced some growth in recent years, and this is one bright spot within the OEM sector. The value of chemicals in appliances is $1.25 billion, with coatings contributing nearly 25% ($305 mil-

lion) of that figure. Around $1.1 billion of chemicals are used in the production of furniture, and coatings account for $970 million of that.

One trend of importance for the auto sector in particular is the growing consumer interest in color. "For many years, silver was the most popular color for cars. Now, there is an interest in a wider array of shades, with blue being predominant and red strengthening," notes Terrence Cressy, marketing communications manager for DuPont Coatings.

Improving technology to be more environmentally compliant and to meet changing consumer demands is also necessary for success in the automotive coatings market. DuPont has developed an innovative "wet-on-wet" primer and coating system used by Ford that makes it possible to do two-tone paint application in one pass through the oven. Its eco-process eliminates one oven baking stage. Both processes save on energy and increase productivity and efficiency. The company also is working with Daimler Chrysler on a 90+% high-solids solvent-based coating.

The same cost pressures are facing paint and coatings manufacturers in the auto sector as in other segments of the industry. "The solution to the cost pressure issues is to work with suppliers to be more productive and find ways to utilize technology more effectively," says. Companies also need to establish a strong presence in emerging countries such as China, India, and those in Eastern Europe, in response to global expansion in the automotive industry.

Increasing efficiency and productivity will be the watchwords for success in 2006 for all sectors of the paint and coatings market. "Strategies that are exclusively based on driving technology will not fare well," says Mr. Brown. "Companies trying to gain market share based on specific technology—for example, low-VOC formulations or special new resin characteristics—will not make great gains. The exception will be niche technologies, such as products aimed at special applications like green building construction," he further notes.

The coatings industry is now driven by management of the supply chain rather than by bringing new technology to market. "Strategies based on driving efficiencies into the entire supply chain will be successful," Mr. Brown asserts. Reducing cost and increasing efficiency will provide the greatest gains. Because of the increasing globalization of the industry, the need to have an extensive supply chain and manage it carefully is all the more important. In addition, companies with a regional focus may eventually be unable to compete with their globally oriented counterparts. It will be an interesting year. CT

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