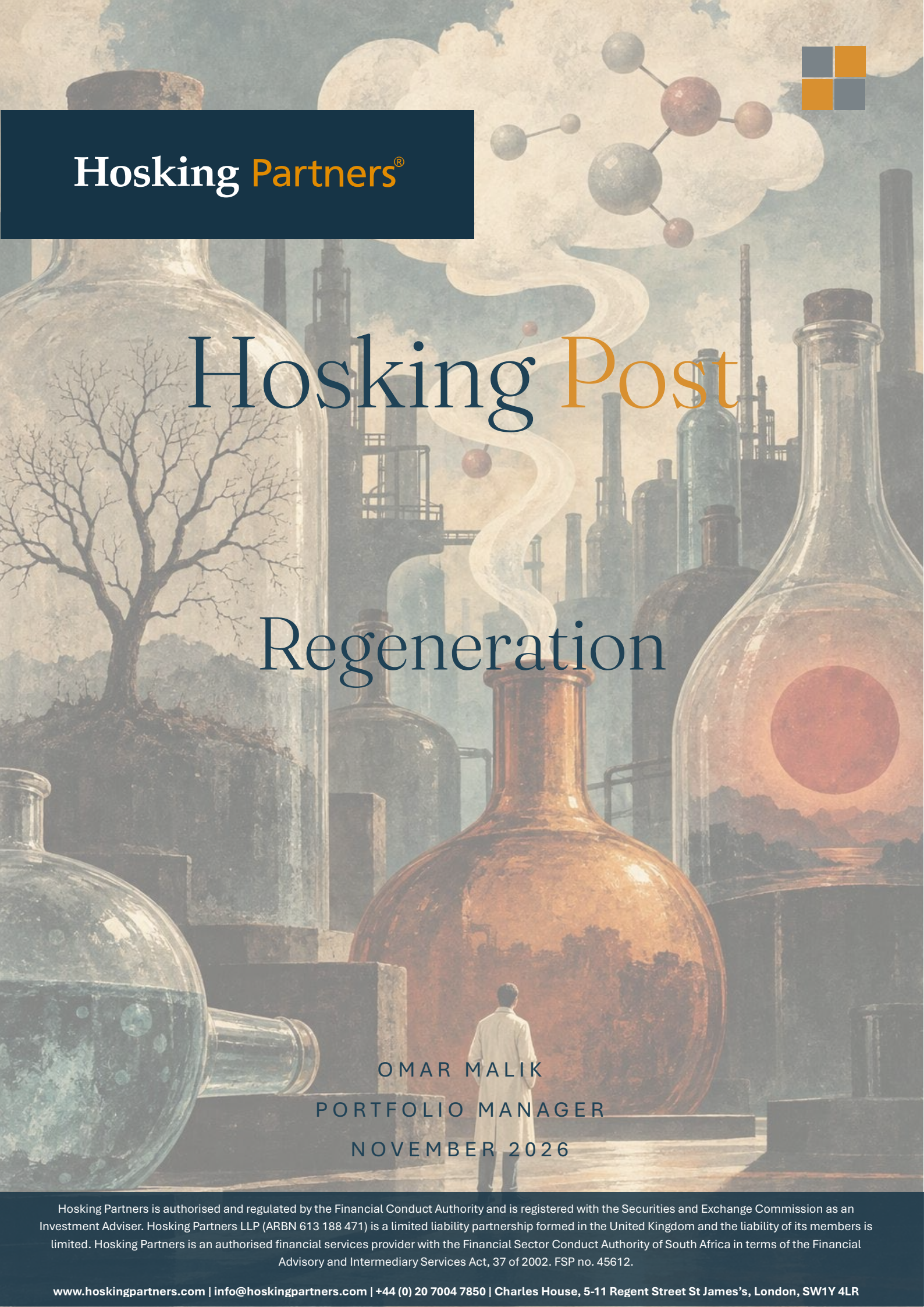


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Regeneration

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PORTFOLIO MANAGER

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Regeneration

> “Nature restores one thing from the other, nor does she permit anything to be born without the aid of another's death.”
>
> LUCRETIUS

Last year, in our piece Metamorphosis, we described the severe downturn in the chemicals industry. Weak industrial demand, post-pandemic destocking, higher energy costs and China's vast capacity build-out had arrived together, and the effect, particularly on European companies, was to drive share prices to multi-decade lows.

These unique circumstances began with the pandemic. As global supply chains seized up, customers in almost every end market ordered more chemical products than they needed in order to protect their own production. End markets that had historically moved independently were suddenly ordering in unison, which exaggerated the upswing. When this temporary demand faded, the same synchronisation worked in reverse, and chemical companies faced a prolonged period of destocking and falling prices. Costs, meanwhile, were rising: Russia's invasion of Ukraine led to the curtailment of pipeline gas supplies to Europe and dramatically increased energy costs for heavy industries such as chemicals. With plant utilisation at record lows, the industry's high fixed costs turned falling volumes into a steep deleveraging effect on profits. As just one example, utilisation rates for ethylene globally fell to 70-80% by year end 2025, levels not seen since the 1980s.

Beneath this cyclical downturn lies a more significant supply cycle, which has pushed the industry into its worst slump in 40 years. Excess capacity, most of it built in China, has undermined the industry's economics, particularly in Europe. Most European petrochemical producers use naphtha, a product of oil refining, as their main feedstock. Feedstock costs differ little between the regions that rely on

naphtha, China among them. What separates them is scale: the far larger, more modern plants that China has built over the past decade have improved profitability relative to the sub-scale, higher cost plants in Europe, most of which were built decades ago.

In this environment, we have found value in a basket of European and US chemical companies that we believe will emerge from the downturn with their competitive positions intact. In a deep and prolonged downturn, depressed earnings and uncertainty about when cash flows will recover often leave assets trading at a significant discount to their replacement value. Yet, as with all commodities, the cure for low prices is low prices: persistently thin cash margins eventually force consolidation and restructuring, at both the company and the industry level. Until the recent events in the Middle East, margins in the two largest plastics, polyethylene and polypropylene, had been close to zero for three years. While visibility on capacity closures in China remain low, we have seen meaningful closures in Europe, Korea and Japan.

Valuations reflect a pessimistic view of the industry's future returns on capital. JP Morgan estimates that the market values the sector at $1.5–2 per kilogram of product sold, against a replacement cost of $3.5–6. On that basis, the entire plastics industry, which produces about 530 million tonnes a year, could be bought for roughly $900bn, and enterprise values would need to rise two- to fourfold before new investment made economic sense. From the bottom of the 1980s cycle, chemical company share prices rose two- to threefold.

A problem with Chinese characteristics

> *"China's super cycle of capacity additions has come to an end, structural change in China is under way."*
>
> *Ineos, Capital Markets Day May 2026*

When we wrote *Metamorphosis* last year, our working assumption was that the losses being incurred across the industry would, in time, slow the pace at which new capacity was built. With hindsight, we did not give enough weight to China's willingness to keep

building through a weak domestic market and negligible margins, and the downturn has consequently proved longer and deeper than we anticipated. This matters for our thesis because the argument that Europe's difficulties are cyclical rather than structural rests in part on supply eventually responding to price. Should the wave of Chinese capacity fail to abate, it is not certain that European producers will be the ones to serve demand when it recovers.

To understand why China has continued to build, it helps to begin with the incentives of its domestic refinery industry. As electric vehicles erode domestic demand for gasoline and diesel, Chinese refiners have been shifting from transport fuel to chemicals feedstock, a move Beijing has explicitly encouraged. The newest integrated complexes are designed to convert 40% of each barrel into chemicals, against the 8-10% of naphtha that a conventional refinery yields, and that output requires crackers and other downstream plants to consume it. This shift has coincided with a regulatory deadline. China has committed to peak carbon emissions by 2030, and the industry’s expectation that new crackers will be difficult to permit thereafter has led all domestic players to accelerate construction before that date. Both forces have reinforced a long-standing ambition for self-sufficiency in a country which, as recently as 2024, accounted for about 40% of global polyethylene demand but only 20% of production, and which imported almost half of what it used.

The resulting investment is of a scale the industry has not seen before. Industry consultants expect China to add about 28 million tonnes of ethylene capacity between 2025 and 2030, which is more than the whole of Europe's capacity of roughly 21 million tonnes and equivalent to around 12% of the global total.

The striking feature of this expansion is that it has been built towards the upper end of the global cost curve. Ethylene, the world's most widely produced petrochemical, is made either from ethane, a cheap by-product of oil and gas production that is available in volume only in North America and the Middle East, or from naphtha, which is priced off crude oil. Either feedstock is "cracked" at very high temperature in a plant, known as a cracker, that costs several billion dollars to build. Producing ethylene in an ethane cracker typically costs 60–70% less than in a naphtha cracker,

which is what makes the curve so steep. China, like Europe, relies largely on naphtha, and its advantages lie in cheap capital and the ability to build large plants quickly rather than in feedstock. With margins on naphtha crackers close to zero for most of the period since mid-2022, the consequences are now visible within China itself: Sinopec's chemicals division lost RMB 1.3bn in the first nine months of this year, SABIC's Tianjin joint venture has lost SAR 4bn in four years, and even LyondellBasell's venture, among the lowest-cost crackers in China, is loss-making.

With the property market in decline, Chinese domestic demand has remained weak, and the new capacity has both displaced imports and pushed surplus product into global markets. The rest of the world has borne the burden of adjustment. Europe has closed about 5 million tonnes of ethylene capacity over the past five years, a fifth of its total, and most of its remaining plants are 30 to 40 years old and sub-scale. In South Korea, producers and the government have agreed to permanently close between 2.7 and 3.7 million tonnes, while Japan, which has no feedstock advantage and has lost its export market in China, faces perhaps the greatest pressure of all. Announced closures worldwide now amount to 16 million tonnes, or about 7% of capacity. This is only half the proportion that closed between 1981 and 1983, when the industry last faced a slump of this magnitude, and JP Morgan estimates that a further 20–25 million tonnes will need to be closed, delayed or cancelled if the market is to return to mid-cycle conditions by 2030. Europe is unlikely to contribute much more: the closure of the Strait of Hormuz, which at its peak removed almost a fifth of global ethylene supply, lifted European margins and persuaded the owners of plants that might otherwise have shut to keep them open. A greater share of the adjustment must therefore come from China.

The first signs of restraint

Early signs suggest this is beginning to happen. Beijing's "anti-involution" campaign, which is aimed at excess capacity and deflation across Chinese industry, includes a plan to phase out petrochemical plants more than 20 years old. This alone will not be enough, because most Chinese capacity is considerably younger than that and few plants are likely to close. The more important question is how much more will be

built, and here recent evidence is encouraging. State-owned Sinopec, China's largest chemicals producer with about a quarter of the country's ethylene capacity, has indicated that its net additions under the 15th Five-Year Plan will be about 3 million tonnes, roughly half the 5.6 million added under the previous plan. Its chemicals capital expenditure this year, at RMB 28bn, is 35% lower than last year and well below the 2021–25 average of RMB 49bn. PetroChina, the country's other state-owned giant, has yet to give comparable guidance, but we expect it to follow a similar path, since it answers to the same policy priorities. Industry forecasts are moving in the same direction. The consultancy CMA reduced its forecast of Chinese additions to the end of 2028 by about 5 million tonnes between June and August, and by one estimate, 10–12 million of the 28 million tonnes expected by 2030 will be cancelled or delayed.

None of this allows us to say with confidence that the cycle has turned. Most of the projects already under construction, many of them with foreign partners, will be completed, and 2027 and 2028 are likely to remain difficult years. Nevertheless, China's mercantilist model, which fills its trading partners' markets with surplus goods, cannot expand indefinitely without provoking a response, and Europe has already begun to impose anti-dumping duties on Chinese chemicals. It is also notable that, for the first time in this cycle, China's largest producer is itself signalling that it intends to build less.

Positioning for the cycle

These developments have shaped how we have repositioned the chemicals basket over the past two years. If China's advantage lies in scale and cheap capital rather than in feedstock or technology, then it is most damaging where products are undifferentiated and where competitors share its cost base. It is least damaging at the two ends of the industry: among basic producers with a structural cost advantage that China cannot replicate, and among specialised businesses serving markets that are too small, too technical or too dependent on customer relationships to reward a new entrant. We have accordingly reduced our exposure to the ground

in between and reinvested the proceeds at either end, with the greater share going to the latter.

Within basic chemicals, we have concentrated our exposure on low-cost producers such as LyondellBasell, whose US crackers run on ethane and therefore sit at the opposite end of the cost curve from the naphtha-based capacity being added in China.

We sold our holding in Lanxess. Our original investment case, that the company would be the "last man standing" in a number of European product chains as weaker competitors closed, is likely to hold, and it has been reinforced by the European Commission's growing readiness to act against dumped imports. Two developments nevertheless changed our assessment. The first was financial: Lanxess had been counting on roughly €1.2bn from the sale of its 41% holding in the Envalior joint venture, but its partner, Advent, chose in March not to proceed this year, and the next opportunities do not arise until 2027 and 2028. That leaves a relatively commoditised company carrying significant debt amid considerable external pressure. The second was more fundamental. Much of what Lanxess makes is "semi-speciality", sold to a specification rather than on its performance in a customer's formulation, and we fear the market may be underestimating how quickly Chinese producers are moving into this territory.

The proceeds have gone into businesses whose defences do not depend on the cost curve. We added materially to Croda, for reasons we set out in more detail below. We also established a new position in IMCD, a distributor of speciality chemicals that connects manufacturers with the many smaller customers they cannot economically serve themselves. IMCD should benefit from the very trend that led us to sell Lanxess: as Chinese producers move into semi-speciality products, they will need specialised distributors to reach local customers in Europe and the United States. Both companies’ shares trade at a deep discount to their historical valuations.

Croda International Plc: Restoring returns

Our largest holding in the chemicals basket is Croda, which began in 2024 as a tail position held by one of our five portfolio managers and has since grown to around 1% of the portfolio, with four of the five now owning it.

Croda is a UK-based producer of high-value, low-volume speciality ingredients for consumer care and life sciences. Its products include beauty actives that substantiate claims such as ‘anti-wrinkle’ in skin creams, high-purity excipients that carry a drug’s active pharmaceutical ingredient, and film coatings for agricultural seeds.

The model has three features that make for an attractive business model: the ingredient is a small part of the customer’s cost but critical to how the product performs; it is costly to switch; and it is consumed with every unit sold. Once a formulation is set, beauty brands and drug manufacturers are extremely reluctant to change what goes into it, because doing so means re-testing the product and, in pharma, going back to the regulator.

Croda has built leading positions in several niche end markets by using its direct sales force to develop tailored products in collaboration with customers. This embeds the company in their supply chains, contrasting sharply with most chemical companies, whose profits depend on filling large plants with hundreds of thousands of tonnes of commodity-like product. In the words of Croda’s chief executive, “We are a direct selling machine with back-integrated factories. It’s a customer-intimate model that drives innovation”.

These characteristics underpinned our view that Croda would prove resilient to Chinese oversupply. So far, China’s chemical build-out has focused on self-sufficiency in essential commodity chemicals, where its advantage is scale: world-scale plants, low-cost capital, and a willingness to export surplus output at marginal cost. This is decisive in commodity and semi-speciality chemicals, where products are made to a published specification and the lowest-cost producer prevails. It is

considerably less effective against the Croda model. A cheaper substitute offers the customer a small saving on a minor cost, but at the risk and expense of reformulating the product. Moreover, in many of these niche markets, products are sold by the grams or kilograms, which negates the advantage of scale.

Instead, we concluded that the decline in Croda's profitability was specific to the company, stemming from the nuances of its manufacturing set-up and its growth-oriented capital allocation. More than half of its sales are generated at eleven multi-purpose sites, each producing ingredients for beauty, crop protection, and industrial customers on a common fixed-cost base. Because no site depends on a single end market, Croda could direct capacity to where demand and pricing were strongest and consistently run its plants at high utilisation rates. This flexibility, diversification, and pricing power allowed the group to sustain operating margins of 24–25% from 2012 to 2019, regardless of the business cycle, an exceptional result for the chemicals sector.

The pandemic broke this pattern. In 2021, all three end markets boomed at once, and the shared sites reached full capacity. Croda responded by raising prices sharply, walking away from lower-value business, and selling most of its industrial division to Cargill, expecting growth elsewhere to absorb the freed capacity. In reality, the high demand during the pandemic was unsustainable, driven largely by customers building inventory in response to supply chain concerns. From late 2022, customers began to run down those inventories, initially in home and personal care, then in crop protection in 2023, and finally in pharma and industrial markets in 2025. As every market contracted, utilisation at the shared sites fell to an unprecedented low of 30% before stabilising at around 50–60%. To rebuild utilisation, Croda then had to concede on price to win back the volume it had turned away, further depressing margins.

The severe decline in volumes was compounded by a period of heavy investment. Croda had long been successfully managed for growth, with incentives that rewarded topline expansion over returns on capital. From 2020, management accelerated its efforts to build a more differentiated portfolio. The company acquired

Iberchem in emerging-market fragrances, Avanti in lipids for drug delivery, and Solus Biotech in ceramides; constructed new plants in India and China; and expanded its pharmaceutical capacity to meet surging demand for mRNA-based medicines. In total, Croda has invested more than £2bn, divided roughly equally between acquisitions and capital expenditure.

When the cycle turned, the company was therefore ill-prepared for contraction. The acquisitions were expensive and had not been fully integrated into an operating model designed around shared sites; the new capacity had yet to generate a return; and ballooning costs received little scrutiny while growth was strong (administrative expenses rose from 18% of sales in 2019 to 26% in 2024). This combination reduced operating margins from 25% to 17% and returns on capital from above 20% to the mid-single digits, while the share price fell more than 70% from its 2021 peak.

Despite this significant deterioration in financial performance, we concluded that each of these problems was cyclical or correctable rather than structural, and that the balance sheet was strong enough to weather the downturn. Around the time we began to increase our investment in 2025, the company appointed a new chief financial officer, launched a £100m cost savings programme, reduced capital expenditure from 11% to 6% of sales, and ruled out any further large acquisitions. Together, these are the ingredients for a higher returns on capital as volumes recover.

We were offered an opportunity to engage with the chair of Croda's remuneration committee in support of the formal introduction of a return on invested capital (ROIC) measure into the long-term incentive plan. While we believe return on ROIC should always be a central performance measure for capital-intensive businesses, we felt it was particularly important at this juncture, given the significant deterioration in returns caused by excessive investment over the prior decade. Such a measure would better align the interests of management and shareholders over the medium term. It was subsequently introduced with a 25% weighting in the 2026 long-term incentive plan. Although we argued for a greater weighting, subsequent discussions with management indicate that the short term annual bonus will also be revised to prioritise capital efficiency and margins.

By early 2026, we believed the shares were significantly undervalued, despite growing evidence that the turnaround was bearing fruit. Given this, we felt the company's shareholder return policy of a 40-50% payout ratio in the form of dividends was not optimal for long-term value creation. We wrote to the board encouraging it to capitalise on the undervaluation by repurchasing shares, which were trading at a 15-year low price-to-earnings multiple of around 15 times 2027 earnings. We argued that reducing the number of shares outstanding would benefit long-term shareholders, which includes the majority of Croda employees, who have endured a long and difficult period of underperformance. A buyback would also be an important tool for reducing the company's equity capital to meet the target of ROIC above 10%, thereby supporting a re-rating of Croda's valuation multiple towards historical levels. Just as the board had seen opportunities to acquire assets to reposition the portfolio for long-term growth, it should now consider the merits of repurchasing the company's own shares, given the considerable potential for recovery. This was especially important because high quality chemical assets such as Croda are rarely available at discounted prices, which leaves the company increasingly vulnerable to others exploiting the undervaluation.

The letter was well received by the company, and we have since had a robust debate with the management team on the merits of a buyback. Although the company has not yet announced one, our discussions suggest that the question is one of timing rather than a difference of opinion on the merits.

Croda is a good example of finding compelling at a industry trough and the benefits of being a long-term, engaged shareholder, who can provide input aligned with value creation over years, not quarters.

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