



# Metamorphosis: The capital cycle in chemicals

- European chemical stocks trade below the cost of rebuilding their plants, reflecting extreme pessimism after energy shocks and inventory destocking.
- As European re-industrialisation, green demand and constrained new capacity converge, earnings and ROIC could rebound sharply from today's cyclical trough.
- We favour names that are reallocating capital from commoditised units to higher-margin, lower-carbon specialties, signaling disciplined, responsible, and forward-looking leadership.

*"Omnia mutantur, nihil interit."*  
(Everything changes, nothing perishes.)

Ovid

**Alchemy, the speculative precursor to modern-day chemistry, sought to turn base metals into gold.** While that transmutation proved more useful as allegory than practical possibility, the modern chemicals industry is no stranger to transformative change. Today, the industry stands at the nexus of powerful global forces: the energy transition, geopolitical shifts, and an emerging trend towards European re-industrialisation. The products that chemicals companies produce underpin much of modern life – from cosmetics and agriculture to medical and packaging – making their survival and evolution a matter of strategic importance.

**Yet today's market views European chemical firms with pessimism,** expecting sustained pressure from energy scarcity, restrictive ESG policies, and geopolitical volatility. These headwinds, accelerated by the curtailing of Russian pipeline gas since the invasion of Ukraine, have resulted in a perfect storm for the sector, pushing earnings to near 15-year lows. But beneath the surface, a powerful shift is unfolding.

**In this article, we explore the rationale behind an investment thesis** that sees chemical companies as potential alchemists ready to conjure renewed value from a harsh downcycle. The Hosking Partners portfolio is invested in a basket of four such companies: **Lanxess**, **Synthomer**, **Croda**, and **LyondellBasell**.

**These businesses have management teams that embody the long-term mindset** that we value in management teams, and which defines our approach to

responsible investment. Whether it is by reducing the energy intensity of production, meeting demand for more sustainable products, or repurposing legacy assets for the challenges of the future – all while exhibiting capital allocation discipline – we believe these companies are well-placed to capture the upside as the chemicals cycle rebounds.

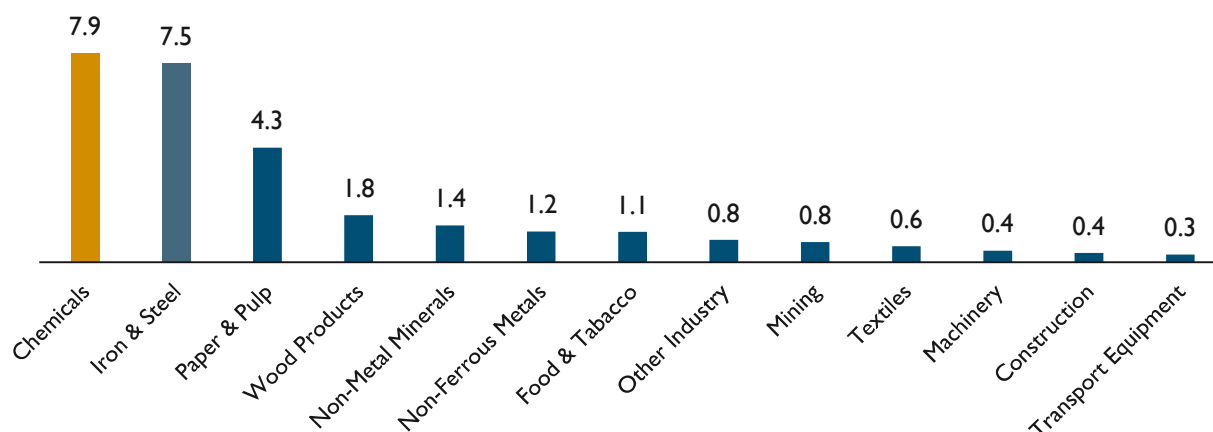
## The perfect storm

**In the wake of the pandemic, the chemicals industry found itself in an almost unprecedented predicament.** Initially, as global supply chains faltered, customers stockpiled raw materials: everything from basic feedstocks to high-end specialty chemicals. When supply chains began to normalise, these same customers reversed course, rapidly destocking their inventories. Meanwhile, the surge in energy prices in 2022, exacerbated by geopolitical tensions, hit the energy-intensive chemicals sector hard. This effect was multiplied in Europe, where (largely Russian) natural gas had become both a critical primary feedstock and power source, and where the energy cost per dollar of sectoral economic output is especially high (see Figure 1, next page).

**This collision of events represented a 'double whammy' for chemical manufacturers.** First, they were forced to sell expensive inventory produced at high energy prices. Second, they suffered from reduced operating leverage, as low utilisation rates meant that fixed costs were spread over fewer units of production. For executives who have endured multiple recessions, many labelled this the worst downcycle of their careers. Evidence can be seen in Europe's largest chemical clusters – such as Ludwigshafen in Germany – where major



**Figure 1: European industry energy intensity**  
Terrawatt-Hours / €bn GDP



Source: Thunder Said Energy

producers have been temporarily shutting down or mothballing key facilities to stem losses.

**Yet investors must remember that the chemicals sector is cyclical.** Today's low earnings do not necessarily reflect the true earnings power of these businesses, especially once energy costs normalise and destocking cycles end. The waves of low demand and high input costs will eventually subside, and those with the foresight to buy when assets are depressed often stand to benefit the most from the subsequent upswing.

## Valuations: Below build costs?

**Chemicals companies frequently maintain large physical plants.** These are hard assets that take billions of dollars in capital expenditures to build, maintain, and operate. Yet the four companies in the Hosking Partners portfolio currently trade below the tangible assets recorded on their balance sheets. In other words, the market valuations for some of these firms are effectively pricing them below the cost it would take to rebuild their physical infrastructure from scratch.

**This is not simply a cyclical bottom, but a sign of extreme market pessimism.** In effect, the market is pricing in the possibility that large swathes of the European chemical industry may not exist at all in a decade. And yet a shifting energy and supply chain landscape, alongside efforts to rebuild regional industrial capacity, could act as powerful counter-currents to that consensus view.

**In a normalised earnings environment** where demand is more robust, and feedstock prices stabilise, earnings could rebound significantly. The chemicals cycle typically reverts more quickly than traditional commodities like copper or iron ore, because chemical

producers can swiftly reduce output, accelerate cost savings, and draw down inventory to generate cash in downturns. Once demand resurges, prices often snap back, driving an outsized earnings recovery.

## Capital cycle shifts

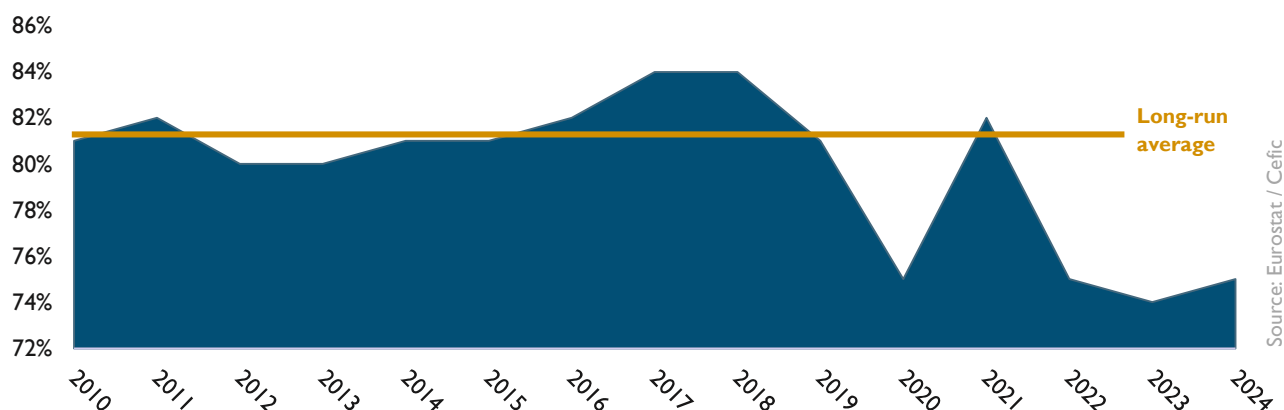
**The logic of the capital cycle** shapes the trajectory of any commodity-influenced sector, and chemicals are no exception. Over the past decade, several trends have emerged across various geographies.

**In Europe, the chemical industry has enjoyed a stable position** thanks to advanced technology, skilled labour, and proximity to major end markets. However, the 2022 energy crisis undercut Europe's feedstock competitiveness. In response, many European players, have announced closures of older, less efficient cracker capacity (ethylene and propylene production units). Some industry estimates suggest that as much as 20% of Europe's cracker capacity has been shuttered or earmarked for closure over the last year. Beyond cyclical rationalisation, these closures also reflect a strategic shift. In a region increasingly focused on energy security, industrial resilience, and decarbonisation, we see leading players selectively exiting commodity petrochemicals to double down on specialty segments aligned with long-term demand – serving sectors such as life sciences, construction, green materials, and food security.

**In the US, the shale revolution led to a wave of capacity expansions** as cheap natural gas liquids provided a feedstock advantage. Yet the bulk of these projects have now come online, and producers are unlikely to greenlight major new projects until there is evidence of improved margins. LyondellBasell, for example, has publicly signalled caution on new build-outs, opting instead to focus on improving its existing footprint



Figure 2: EU27 Chemicals Capacity Utilisation



and returning capital to shareholders. Furthermore, one of LyondellBasell's largest competitors, Dow, recently paused construction of its \$10 billion cracker in Alberta.

**Meanwhile, over the last five years, China has been the most significant driver of new supply globally**, driven by government ambitions to become self-sufficient. As a result, the entire region has been operating around break-even for four years, given soft local demand and a lack of regional feedstock advantage. In response, 10% of the nameplate Asian ethylene capacity has been taken offline, with the hope that pricing will recover. Ultimately, we believe much of this capacity will be closed. While China is likely to continue to add capacity through to the end of the decade, LyondellBasell, the global leader in the technology for new plants, is seeing a slowdown in licensing sales in China.

**Against this backdrop, capital expenditures are declining across multiple regions:** Europe is closing older and less efficient plants due to the energy cost spike and policy headwinds, and capacity utilisation is at multiyear lows (see Figure 2, above); North America is nearing the end of a capacity expansion wave sparked by the shale revolution; and Asia (particularly China) is grappling with the reality of overbuilt facilities and sluggish local demand. The combined effect is a slower pace of new capacity coming online, which should gradually tighten the supply-demand balance.

**When the next cyclical upswing in demand arrives** (even if it's modest), those producers who have kept their facilities efficient, specialised their product lines, or judiciously rationalised excess capacity may see healthier margins. In other words, the industry's inclination to rein in capital spending now could end up positioning it for stronger profitability once consumer and industrial markets rebound.

## Time to harvest?

**Over the last decade, many chemical companies embarked on aggressive M&A sprees**, buying up specialty firms and building or expanding plants to carve out new markets. Today, confronted by tight capital markets and lower share prices, management teams seem to be entering 'harvest mode'. Most of these firms have scaled back capital expenditures for the next several years.

**With fewer acquisitions in the pipeline, the prevailing mood is one of consolidation and optimisation.** Executives in our basket have signalled that if valuations remain depressed even as earnings recover, they are ready to employ buybacks, which could drive meaningful per-share value accretion. This shift in capital allocation strategy could also mean higher free cash flow (FCF) generation in the next decade than in the previous one, precisely because companies are not spending as aggressively on expansions or acquisitions. Looking at the last 10 years of FCF for each company relative to its current market cap, Synthomer stands out. Its cumulative FCF for the period is equivalent to 372% of its present market cap. LyondellBasell follows with 148%, Lanxess at 64%, and Croda at 36%. These ratios offer a glimpse into the dry powder these businesses have historically been able to generate. If the next decade sees less capital outlay and a return to cyclical normalcy, that cash generation potential could be significant.

## Downside protection

**Commodities like copper or oil often present investors with the 'bleeding bucket' problem:** in a downturn, mines or wells can continue to produce at a loss, draining balance sheets as they wait for a price



recovery. Chemicals, however, behave differently. Since manufacturers can reduce throughput rapidly and scale down production runs, they can cut variable and some fixed costs more effectively. Additionally, the liquidation of existing inventory can free up cash. This dynamic can result in record cash generation even when earnings are under pressure.

**For example, when global demand for ethylene dropped dramatically in 2020,** LyondellBasell idled certain facilities, cleared inventory, and focused on core assets. Despite the drop in revenues, the company still managed to strengthen its balance sheet through prudent working capital management. Chemical prices are notoriously volatile and can rebound with surprising speed, which is precisely why many investors are spooked by the sector. Ironically, that is also the source of outsized opportunities.

## Indicators of recovery?

**Beyond the financial statements, there are tangible signs that the cycle may be turning.** Natural gas futures in Europe have fallen dramatically from their peaks in 2022. If prices remain moderate, European chemical plants will regain some cost competitiveness. Meanwhile, although Chinese growth has not recovered to pre-pandemic levels, a steady return of consumer demand, especially for durable goods and automotive, is a positive signal for chemical end-markets. Even modest improvements in construction or infrastructure spending tend to cause a positive knock-on effect for base chemicals. Furthermore, many Western producers continue to pivot toward increasingly sustainable and 'green' processes, which can command price premiums and may insulate margins from commodity-like competition.

**Our portfolio holdings are distinguished by their management teams' thoughtful approach to this dynamic.** Each is confronting Europe's structural headwinds head-on and turning them into a competitive advantage while the market is fixated on the current earnings trough. Croda has doubled-down on critical ingredients for pharma, selling its last industrial chemicals unit in 2022 and shifting capital toward drug delivery systems for vaccines and mRNA/gene-editing therapeutics where historical EBIT margins have been above 25%. Over the last eight years Lanxess has pruned out its burdensome commodity limbs (rubber, polyamides) to reveal nine niche franchises where it already holds a top-three market share and – crucially – are exposed to far lower energy and raw-material intensity. LyondellBasell is running a hard strategic review of its European footprint, while cheaply repurposing uncompetitive assets to produce green feedstocks that

already command contracted price premia from FMCG buyers with sustainability mandates. Repurposing that capital costs barely a tenth of annual capex. And under new leadership, Synthomer has sold or shut enough commodity units to shrink its site count by a third, re-orienting the portfolio toward specialties that can sustain higher returns. These actions are precisely the long-term, capital-disciplined behaviours we look for as responsible investors; they will not rewrite earnings overnight, but they lay the foundations for a structurally higher ROIC when the cycle turns, a nuance that seems missed by a market consensus hooked on quarterly numbers.

## Conclusion

**The long-term investment thesis rests on three critical points.** First, valuations are flirting with or even dipping below the cost to rebuild the physical assets, suggesting substantial upside if normal earnings return. Second, capital allocation has entered a new phase of discipline, prioritising debt reduction, dividends, or buybacks over risky expansions. Finally, the nature of chemical production allows for rapid capacity closure and inventory liquidation in downturns, offering a form of downside protection rarely seen in other commodity-related sectors.

**If history is any guide, cyclical troughs in this industry often precede moments of remarkable value creation,** as was observed in the recovery following the global financial crisis in 2009–2010 or the rebound from the oil price slump in 2016. If European re-industrialisation gains traction – driven by protectionist trade policies, defence spending, and reshoring of critical supply chains – then chemicals could be central to the next wave of industrial growth. In such a scenario, today's valuations appear highly attractive.

**Like the alchemists of old, today's chemical companies may appear to be 'base metals' trading at depressed valuations.** However, with patience and a clear eye on the longer-term supply-demand fundamentals, they have the potential to undergo their own metamorphosis – an alchemy that could transmute today's struggles into a new era of value creation for patient, contrarian investors.

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## References

*References for any data or quotations included in this article and articles elsewhere in this report are available on request.*