

# Sinopec's big picture strategy

The state-owned oil, refining and petrochemical giant serves a government as well as a profit agenda. That makes its moves more difficult to predict



Sinopec could shift from serving as a raw materials supplier for the state to building an international focus

JOHN RICHARDSON PERTH, AUSTRALIA

**W**estern chemicals companies, more often than not, have to do their very best to make money. Thus, when it comes to competing among themselves, companies in the US and Europe can normally assume that they are operating on a level playing-field.

In the case of competition with Sinopec, however, the Westerners must sometimes feel that they are playing soccer uphill in a force 10 gale.

The Chinese oil, refining and petrochemicals major runs its plants "with no regard for the sometimes tumultuous circumstances in the external world," argued Paul Hodges, chairman of UK-based chemicals consultancy International e-Chem in a company profile of Sinopec.

As a result, Hodges has calculated that Sinopec has run its petrochemicals plants at an average operating rate of 102% over the last decade, even during periods of extreme market distress.

"Sinopec has showed no sign of fluctuating operating rates in order to maximise margins in good times or to reduce losses in weaker periods," continued Hodges in the same study.

"Operating rates did drop in 2009 and 2012, but this was more a response to a lack of customer demand rather than a deliberate attempt to support margins by reducing production."

Not surprisingly, this focus on maintaining

high rates of production has fed through to the bottom line. Earnings before interest and tax (EBIT), as a percentage of turnover, averaged just 0.2% in refining and 3.7% in 1998-2012, said the consultant.

"And even the 3.7% owes a lot to the two excellent years of 2004-2005, when chemicals EBIT reached 12.9% and then 8%. Without these two years, chemicals EBIT would average 2.6%," he added.

## THE ROLE SINOPEC PLAYS

"No commercially oriented business would have tolerated such low returns over such a long period," said Hodges.

So, what on earth is going on?

The answer is that Sinopec has, in effect, acted as a utility of the State. Its function has been primarily to maintain supplies of raw materials to downstream industries in order to achieve high levels of employment.

And during China's economic Supercycle, which immediately followed the country's 2001 accession to the World Trade Organisation and lasted until 2012, this strategy was a spectacular success.

Not only did China maintain full employment, but it also achieved double-digit GDP growth as its export-focused manufacturing rapidly expanded.

## WORLD'S LEADING ETHYLENE PRODUCERS

1980	1990	2000	2010	E2015
Shell	Shell	ExxonMobil	Dow	SABIC
Dow	Dow	Dow	SABIC	Sinopec
Exxon	Exxon	Shell	ExxonMobil	Dow
Union Carbide	NOVA	Union Carbide	LyondellBasell	ExxonMobil
Gulf	Union Carbide	BP	Sinopec	NPC Iran
DuPont	USSR State	SABIC	Shell	IPIC
ICI	Lyondell	NOVA	IPIC (NOVA, Borealis)	LyondellBasell
Lyondell	Occidental	BASF	INEOS	PetroChina
Amoco	SABIC	Lyondell	Formosa	Shell
NOVA	PEMEX	Phillips	NPC Iran	INEOS

SOURCE: International eChem





Western demand for China's exports collapsed in late 2008 as a result of the global financial crisis.

But a giant government stimulus package, introduced in late 2008, meant that China's GDP growth continued to expand at around 10%/year. Rapid rates of growth were sustained because the stimulus was invested in large amounts of new infrastructure and industrial capacity.

Sinopec played its role in the economic rescue by continuing to supply raw materials for all of these expansions, even when it was losing money. "As a major state-owned company, Sinopec is better-placed than its smaller customers to absorb periods of losses, when the spread between product and feedstock prices is reduced," said Hodges.

But the old social/economic logic is no longer valid. Sir Arthur Lewis, the Nobel-prize-winning economist, said that developing economies gain a "free ride" in terms of GDP growth as populations move to urban from rural areas.

But after around 20 years, developing countries lose their cheap labour advantages and so have to move up the manufacturing value chain in order to escape Lewis's "middle-income trap". China, as we have discussed before in this column, has already reached this point, with its lack of competitiveness in low-

value manufacturing made worse by its disastrous One Child Policy.

It runs the risk of becoming an old country before it becomes rich enough to afford the enormous social costs that will result from its rapidly ageing population.

Low-value manufacturers, including some plastic converters, have already left China for other Asian countries, such as Vietnam and Malaysia, where labour is more plentiful and therefore cheaper. As Sinopec remains a state-owned company (76.28% owned by the government), a big question therefore has to be: How will the company's strategy change in response to this new macroeconomic environment?

#### GOING FOR DIVERSIFICATION

"In 2013, Sinopec will implement initiatives across the company to enhance the quality and efficiency of its traditional businesses while growing and developing new businesses," wrote the company's chairman, Fu Chengyu, in Sinopec's 2012 report.

This would involve Sinopec further developing its already strong refinery-petrochemicals integration, moving further downstream, diversifying its product portfolio and extending its geographic reach, added Hodges.

An example of diversification was its cumene, acetone and phenol joint venture with Switzerland-based INEOS, said the consultant.

INEOS and Sinopec will invest around \$500m (£375m) in the project, which is located in the Nanjing Chemical Industrial Park in Jiangsu, China.

The complex is expected to be completed by the end of 2015 and will have capacities of 400,000 tonnes/year of phenol, 250,000 tonnes/year of acetone and 550,000 tonnes/year of cumene.

And Sinopec, despite the distinct possibility that China will undergo a sharp slowdown in GDP growth as its economy evolves, is set to continue growing in the more basic, upstream petrochemicals.

For instance, its ethylene output will rise to 13m tonnes in 2015 from 9.5m tonnes in 2012, noted Hodges. This would leave it as the world's second largest C2s producer behind Saudi Arabia's SABIC.

Ethylene output has risen by 13% per year over the last decade, with steep increases in the production of many of the other basic petrochemicals.

If Sinopec carries on growing as planned, where on earth is all this extra production going to end up?

"As it moves into surplus on some products, Sinopec is likely to maintain production rates by building an export position rather than cutting its operating rates," Hodges warned. "This could result in Sinopec building an international position, perhaps via [mergers and acquisitions], in selected

geographies of key relevance to China." Another key issue for Sinopec is feedstock. Whereas it has built excellent refinery petrochemicals integration at its major sites, which include those at Yanshan, Shanghai, Yangzi, Qilu, Maoming, Guangzhou and Tianjin, the company, and of course China as a whole, is short of oil supply.

"China's oil production in 2012 was only 4.2m bbl/day (mbd) – 5% of the global total – whereas its consumption was 10.2mbd – 12% of the total," wrote Hodges.

"Consumption has grown rapidly over the past decade, as a result of industrialisation, and has more than doubled from 1998's level of 4.2mbd level, whilst production only rose 29% from 3.2mbd, although this may now be improving as exploration and production spending brings its rewards," he said.

"This growing shortfall has led China to scour the world for new and reliable sources of oil. It has identified Saudi Arabia as its likely major partner, and in 2009 Saudi oil imports to China overtook those to the USA, historically its major customer, for the first time."

**"Sinopec has showed no sign of fluctuating operating rates in order to maximise margins in good times or to reduce losses in weaker periods"**

**PAUL HODGES**

Chairman, International eChem

More specifically for petrochemicals, Sinopec might bypass the crude-oil problem by taking advantage of China's ample coal reserves, via the coal-to-olefins (CTO) process.

But, as we again have written about before in this column, CTO raises several major environmental concerns, most notably around water availability.

Interestingly, Sinopec's chairman added in the 2012 Annual Report that "we will increase our efforts to develop these initiatives [green and low carbon strategies] and ensure that we are contributing to an ecologically conscious civilisation."

It would be unwise, however, on this basis to write off a major CTO expansion by Sinopec. Job creation in the country's less-developed western provinces, where most of these projects are located, might trump environmental worries.

This further illustrates just how difficult it is to assess a company such as Sinopec, where making money is not always the number one priority. ■



For more news and pricing reports covering the Chinese petrochemical industry, subscribe at [icis.com](http://icis.com)