POLAND:
Chemical Industry in Pole Position

Riding on the wave of a positive conjuncture and a successful EU integration, Poland is now looking to a brighter chemical future. However, the industry still awaits a clearer signal on the privatization front to reach the full impetus of its development potential…

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Since the fall of the Berlin wall, and the end of communist regimes in this part of Europe, Poland has been the darling of Central Eastern European Countries (CEEC) and a major recipient of foreign direct investment. Between 1989, date of the beginning of market reforms, and the end of 2003, Poland was the recipient of a total of USD 72.7 billion. In 2004, chemicals together with rubber and plastics totaled USD 868.3 million, or roughly 8.3% of total FDI received during the year. The reasons behind this interest are numerous but all quite straight forward and easy to understand. First of all factors is size. Poland is a big country with a large population (38.5m) which, it is hoped, will soon turn into a sizeable consumer market once individual purchasing power grows to be at a par with Western economies. The second is location; Poland is blessed with a strategic geographical position in the centre of Europe, with access to the sea and shared borders with a number of countries that include old EU members, new entrants into the EU and non-EU neighbors. With such a location, Poland serves a bridge-like purpose having both easy access to raw materials resources from the Eastern part of Europe and an easy capacity to tap into the commercially attractive markets of the Western part of Europe.

The third main factor of course is cost. In spite of its recent rapid GDP growth, Poland still harbors a relatively cheap labor force and offers surprisingly flexible labor laws that can bring down production costs substantially. Poland is a place where skills will come at a bargain given the high level of education of its workforce, and of scientists and engineers in particular. According to figures provided by Basell Orlen Polyolefins based on a study by the Boston Consulting Group, while blue collar workers were markedly cheaper in China as compared to Poland, white collar workers were on average, 60% more expensive in China.

These three obvious clichés have been enough to gain Poland a most-favored nation status for investors looking eastwards. This in turn has also turned Poland into a sort of regional platform. Foreign investors, rich with the experience of having successfully established a foothold in Poland, have often used the country as the trampoline from which to penetrate other neighboring markets. Indeed, a number of companies actually run their Central and Eastern European operations from Poland, and a number of country managers double up as regional managers. This makes a lot of sense: cultural affinities and historic ties apply and sometimes even linguistic skills can help. A whole generation of Poles used to trade within the former Comecon countries and is therefore familiar with the business culture of its neighbors and the composition of their markets. Also, while being careful not to blur the particularities of each country's development path, it can be noted that several of Poland's neighbors have followed a similar trail of restructuring, privatization and the transformation of their legal framework, etc.

In fact, entry into the EU for Poland and the other CEECs that graduated at the same time was a sort of culmination of a process initiated all the way back in 1989. Perhaps for this reason, and in spite of the tremendous changes that this event should signify, the Poles did not feel that May 1st 2004 -the day of their accession into the EU- generated any kind of tidal wave of change. On the contrary, the general answer to any question referring to the impact of accession a little over a year ago is indifference accompanied by an immediate downplaying of its importance. The truth is that though the date itself was perhaps perceived of as of little consequence, the changes that occurred on the way to accession are of monumental significance and should be seen as a revolutionary process of no small proportions. Poland underwent metamorphosis in the space of merely 15 years, barely a generation… Listening to the 'modern' CEOs that we interviewed in the making of this report, it would be easy to forget Poland's past as a centralized economy and to underestimate the sheer magnitude of the progress that has been achieved. Sure corruption is still rampant, unemployment and over-employment are still major obstacles and privatization is still slow in some regards, but any look backwards should be enough to fill any Pole with pride and the confidence that the future should hold many promises yet. And indeed, thanks to a positive recent conjuncture, the chemical industry is poised to generate 7% to 8% growth this year after posting an already impressive growth of 9.5% in 2004.

The chemical sector can rightfully be seen as a textbook illustration of the economic changes incurred throughout the country at large. This shouldn't be any surprise considering the importance of the chemical activity in the country's economic profile. According to the statistics of the Polish Chamber of Chemical Industry (PIPC), roughly 10% of companies involved in manufacturing are involved in chemicals, representing about 8% of the workforce in industry and 14.1% of industrial output. The chemical industry breaks down into several sub-sectors of which the most significant are basic chemicals (19,4% of total chemical output), household chemicals and cosmetics (19,5%), plastic products (28,4%), pharmaceuticals (12,8%), rubber products (11,3%) and fertilizers (6,5%).

Caprolactam facility at Z.A. Puławy

Smooth takeover of Rokita by PCC A.G. to form PCC Rokita

Poland's chemical sector displays many of the attributes that typify the economy of a centrally-planned system that has rapidly developed to a market-oriented economy. First, there is the wide trade deficit which doesn't seem to subside in spite of growing domestic consumption. In 2003, imports of chemicals (roughly €11.92m) amounted to almost double the value of its exports (€5.93m). This is partly due to the low value of production from Poland, where the value chain still needs to be stretched and partly due to increasingly open borders. With the introduction of open competition and the breaking down of protectionist barriers, foreign products have gained footholds in the Polish market and gnawed heartily at the market shares of local companies. While this has had negative effects in some sectors such as pharmaceuticals, it also acts as a locomotive for growth as it shows how much can be gained from covering the gap between domestic demand and production as some of these imports could be substituted by local products in the long term.

The chemical industry has yet to complete its period of transformation, and the sector still presents a hybrid portrait with some sub-sectors having been completely privatized already (pharmaceuticals and paints, for example, but also most transport and logistics) and others still grappling with a drudgingly slow process tainted with political overtones. This is the case for most of the state-owned heavy chemical synthesis industries that produce either plastics and derivatives or fertilizers or a combination of both. The slow progress, incertitude's and delays of these privatizations are frustrating, but nevertheless and in spite of state ownership, most of these companies have undergone crucial restructuring measures, carried out important investments for environmental and security purposes and have even managed to make themselves profitable in the wake of a very positive conjuncture in 2003 and 2004. In short, they have been well prepared for a change of ownership whose timing is unfortunately still anybody's guess. With elections looming in September, no political candidate is willing to risk a campaign by having a strong stance on privatization. Since the measure has proved unpopular in the past, with the risk of large scale lay-offs and an all too-dangerous impression of "selling off" the crown jewels, the climate is not conducive to any quick decision-making before a new government is in place and decides to take the bull by the horns…

The following report is the product of a number of interviews with industry leaders of several of the sub-sectors in Poland's chemical industry. The report provides readers with an insight into what is a very dynamic sector, in the midst of transformation and evolution. Chemicals in Poland are not only representative of the arduous road the country had to travel to transform its heritage into a modern, performing, market-oriented industry, they also show that for those willing to put the effort in, major benefits can be reaped. While some sort of saturated maturity has already been achieved in some sectors, others are still there to be developed. With available infrastructure, cheap skilled labor, access to raw materials and feedstock, a growing domestic market and perfectly smooth access to the export markets of the EU, it doesn't take that much boldness to aim for a profitable return on investment in Poland.

Foreign Onslaught

In 1989, when Poland emerged from behind the iron curtain, many in the West saw opportunity galore; a gold rush, some argue, with bargains ripe to be picked by those bold enough to make an early foray. Indeed, the many who came have not only gained an unprecedented understanding of the development forces at play in Poland, they have also helped to define its present shape.

Mr. Andrzej Jarzyński heads the Polish branch of Hoyer, a large German transport group that sought to establish a presence in Poland as early as 1991. He reminisced on the past and told us: "It was a challenge for all, but to a certain extent we are all the authors of the improvements that appeared". Transport, distribution and overall logistics were among the first sectors to be fully liberalized, and brought in a number of foreign players either wanting to grab an early position in the market or simply seeking to follow their chemical customers that were moving into Poland. In a logistics market that is increasingly saturated today and where the overwhelmingly dominant presence of Brenntag leaves little room for newcomers, the early approach has proved to have been the correct one. For HSH for example, another German distributor with a very solid Polish base, their early establishment means that they are now thinking beyond the borders of Poland towards its southeastern neighbors. Mr. Friedrich Rather, its President, explained this move: "if you want to work with the bigger suppliers, you need a bigger area to cover". He pointed to the fact that "today businesses are downsizing the number of distributors that they use, and we were asked by several suppliers to also take care of other markets in the region. This is a service that we had to provide to avoid the risk of losing our Polish business. So it was a kind of 'must' but it has proved to be very successful."

All distributors are now in one way or

another upping the value of their Polish operations by adding services in neighboring countries. Mr. Jarzyński of Hoyer told us that he was "convinced that Europe's future is connected with Russia and the Ukraine" and he is not alone in this opinion. The Polish branch of the German distributor Solvadis, for example, though based in Wrocław, are also paying close attention to the big Eastern neighbors, to the point of having hired Ukranian staff to work in their Polish office and, perhaps, prepare for eastward expansion.

For those who came later, often through participation in a bid to take over state-owned entities, the transformation was also quite dramatic. I asked Mr. Mirosław Godlewski to tell me what had changed since GATX, a global fuel and chemical rail car owner that he manages, took over DEC in 2001 and his reply was to say that "it would be more accurate to say that there have been few facts and elements that have not changed within the company…" In this case, DEC was the rail transportation arm of what is today PKN Orlen, Poland's petrochemical giant. In short, it was a mere service department with few commercial imperatives. "Becoming part of GATX not only changed ownership –which people tend to forget is a shock of its own- but it became private, American and international all at once." Almost overnight, it underwent mutation, as Mr. Godlewski reminds us, and applied a customer-oriented business model meant to emulate locally what had proven successful worldwide with GATX's global customers.

A key factor in any transition of this kind is to manage the change of mentality. As transition dragged on, strategy was often absent from the minds of state companies waiting to be privatized. POCH is a medium-sized manufacturer of special chemicals and distributor of lab equipment who has just recently been put into private hands thanks to an investment by Kulczyk Holding. Mr. Thomas Horne and Tomasz Wałesa, President and Vice President of POCH, explain this difficult turnaround very well. "During the last ten years, it was very difficult to have a clear strategy. Most things were just carried out on a day-to-day basis, with no vision. Basically, it just operated in purely 'survival' mode. Even though I think that POCH was in excellent survival mode, that this time was managed very well, it is now time to change that pattern." Two years into privatization, the main objective of management has been "to get out of 'survival' mode and change into 'growth' mode, which is not easy because suddenly you have to invest and to look for new outlets".

In the paints sector, the arrival of foreign investors wanting to take over market shares by buying into the ex-state owned paint companies took place fairly early. As a result, the market in paints is now actually one of the most competitive sub-branches of the chemical sector. It reveals an interesting aspect of the foreign investment onslaught. Western companies with more knowledge of how to operate in free-market economies needed to adapt their strategies to an economy that had embraced the principle of free-market but was still only in early transition stages. It was large international corporations that came in to buy Poland's paint factories: SigmaKalon, Akzo-Nobel, ICI to name a few. The promises offered by a dynamically growing market with rather low indices of consumption (hence poised to catch up with consumption figures in the West) were indeed there, but for companies used to mature markets, where brand awareness and quality matters much more, Poland caused some real teething pain. They arrived in a market driven by prices and where real rather than potential consumption is still quite low. As a result, since they need to float on thin margins, they have become incredibly efficient plants where worker profitability is among the highest in Europe. Interestingly enough, while belonging to a sizeable international group will always help, having local knowledge also goes a long way. The case of Sniezka is revealing. The only surviving independent paint company not to be dominated by the capital of a large foreign group has managed successfully to creep up to 2nd place behind Polifarb PCW in terms of market share, proving that a mixture between western concepts applied to a local reading of the market seems to be a winning formula.

In pharmaceuticals, a similar story took place except most Poles feel that in this case foreigners have played a largely negative role. What they stand accused of is having bought into state companies with no intention of developing production or investment, but just as a means to gain market shares. As a result, domestic companies, which lacked the funds to invest in modern production lines and were producing generics for the most part, found it tough to compete. Again, from a positive trade balance before 1992, pharmaceuticals have plunged into an abysmal negative trade balance. Nonetheless, according to Mr. Lubiewa-Wieleżyński, President of the PIPC (Polish Chamber of Chemical Industries), "pharmaceutical companies have got huge possibilities in Poland as the inhabitants consume large quantities of medicines". And indeed, there have been success stories such as Polpharma that prove that with investment concentrated mostly on cost-effectiveness, competitiveness can be achieved in the manufacture of generic products, particularly when a good domestic positioning goes hand in hand with successful exports towards low-income markets in Eastern Europe. Though a little late, the remaining state-owned polfas –as the pharmaceutical companies were called in the times of communism- have also reacted by forming a conglomerate. It is hoped that the nascent holding between Polfa Warszawa, Tarchomin and Pabianice, the only remaining ones in the hands of the Polish state, will give enough economies of scale to boost profits and secure future development. While still betting on generics, a private company called Adamed also defies the odds by choosing a different strategy. They put in a very respectable amount of research (for a generic company) into the formula of their products and their mode of administration and choose to market a limited offer of blockbusters that are sure to defeat competition rather than to sustain an uneven array of products on pharmacies' shelves.

Even if entry into the EU may have seemed insignificant coming after 14 years of radical and rapid changes, and with most international players entering the market way before accession, Poland is now at a turning point where it must take better advantage of its assets. As Mr. Horne put it, "many companies saw integration into the EU as a threat; only a few saw it as an opportunity. This is difficult to understand because it opened borders, our production costs are much lower, we have competencies and all these add up to an opportunity". The distribution and transport sector may be in a maturing phase of saturation that will lead to consolidation. The paints sector may be horrendously competitive and the pharmaceuticals sector may suffer from underinvestment and an import onslaught, but nonetheless, large chunks of the chemical industry are still very open to investment. Mr. Lubiewa- Wieleżyński reckons that "investment should now concentrate on the final production sector. Its is the underdevelopment of the processing sector which has a negative influence on our trade balance, but the share of chemical products within it, however, is increasing."

A clear message:

Rather than focusing on the past, it is the present and future of the chemical industry we should be concentrating on. The general mood is quite optimistic, despite the problems exposed in the previous chapter. Both 2003 and 2004 proved to be excellent years financially and this positive conjuncture saw most chemical companies make a large operating profit, often after decades of posting numbers in the red. However, this optimism is also accompanied by a very strong and clear desire by all of the people that we interviewed to have a clearer idea of the direction that the state is taking concerning the future of the remaining state enterprises. Overwhelmingly, they all agree that the privatization of the state's heavy chemical industries is the key issue to re-injecting impetus into the sector and to allow for its future development. Mr. Jarzyński (from Hoyer) was emphatic when saying that "despite the very favorable conjuncture of 2004, the privatization of the chemical sector remains a crucial issue as we're all aware of the fact that every conjuncture is a temporary phenomenon". Mr. Lubiewa-Wieleżyński echoed this by reiterating that "first and foremost, a clear message has to be given to investors by the government's agent Nafta Polska" (the entity in charge of the privatization strategy on behalf of the Ministry of Treasury, who owns the shares of these companies). According to calculations elaborated by the PIPC over which he presides, Poland needs about 5 billion euros of investment over the next 10 years to meet development requirements. And since PKN Orlen is the only potentially serious local investor, that means that most of this amount will have to come from abroad.

Unfortunately, despite the existence of a well laid-out strategy which involves floating the shares of Zakłady Azotowe Puławy (Puławy) and Zakłady Chemizne Police (Police) on the Warsaw stock exchange and offering the other 4 (Azotowe w Tarnowie-Mościcach (Tarnów), Zakłady Azotowe Kędzierzyn-Kozle (ZAK), Zakłady Chemizne Organika-Sarzyna (Sarzyna) and ZACHEM) to strategic investors, most observers remain skeptical and uncertain. Mr. Benedykt Michewicz, President of the Board of Anwil, explains matter-of-factly that “the general rule is that before every General Election, the privatization process decelerates as the candidates are afraid to lose the votes of those who oppose privatization. After the election, it accelerates again.” In short, with General Elections due in September, the whole process has been put on hold while awaiting their outcome, which could still change the face of privatization as well. As Mr. Michewicz goes on explaining, the debate over the need for privatization is not a closed one in political forums. “Many major Polish companies tend to be recognized as strategic by certain politicians, who simply don’t want to lose control over these companies.” At the same time, he considers it fortunate that Anwil wasn’t among those considered ‘strategic’ when it went through privatization. Now a subsidiary of PKN Orlen producing PVC and fertilizers, it recognizes that it owes its present form to the restructuring and the investment that were carried out after privatization. “It is a universal truth that doing business with a private company is easier than with a state-owned company. Anwil’s position right now is due to the fact that the privatization process in the company finished ten years ago”. Of course, the social cost can appear initially high to any politician, particularly in a country that suffers from endemic unemployment that soars at just under 20% of the workforce. However, Mr. Michewicz concluded his interview by formulating “the hope that more and more people will start to realize that privatization is absolutely necessary for any company’s growth in the long run, even if it isn’t easy to change the people’s mentality…”

Indeed, other companies that have gone through the trauma of privatization successfully can attest to the benefits of transformation, even by political criteria. PCC A.G. is a medium-sized German logistics and trading group that decided to make Poland its base to diversify into chemical manufacturing. They invested in two main state owned companies in Poland, Rokita and Synteza, and in both cases have achieved a very respectable turn-around. Mr. Alfred Pelzer, member of the board of PCC A.G. and Mr. Mirosław Krutin, President of PCC Rokita, both explain that though “at the very beginning we might have been received with some hostility as a foreign investor taking over Polish companies, but now people understand that we have a long-term strategy to develop in Poland. In fact, some German companies even thought that we were a Polish firm!” And while their operation is still in its early stages of development, with several levels of investment planned for expansion at PCC Rokita and stabilization needed at PCC Synteza, they have already achieved enough for their example to be a strong pro-privatization argument. “PCC raised some funds from Brussels, contributed to different companies’ growth and increased their efficiency and capacity in a short time. The government is satisfied with our activity. In the case of Synteza for example, it was on the verge of bankruptcy and we brought it back to life. We also hired more people, an increase from 80 to about 160 in Synteza and proved that even a small scale production can become successful, provided that it’s well organized and managed.”

Basell-Orlen Polyolefins’ plant in Płock.

If the 6 companies that remain to be privatized follow a similar path, the chemical sector of Poland could really then fulfill its true potential. To be fair, even though the question of their ownership remains unresolved, most of them have become joint-stock companies and undergone severe restructuring that should allow for a smooth transition in the future but already allows for improved results and a more independent decision-making process. Mr. Zygmunt Kwiatowski, President of Puławy, told us that “the main changes occurred in the sphere of management, but investment opportunities have also improved”. He is referring to the decisions that have been taken to erect two brand new melamine lines that now make Puławy the 3rd biggest melamine manufacturer in the world. Restructuring also allowed the company to “progress in the direction of a structure based on profit and cost centers which are only concentrated on manufacturing specific products such as melamine or fertilizers”. In other words, they are slowly getting rid of unnecessary subsidiaries providing unrelated services that tend to only exist in state-owned companies with a heavy historical heritage, thereby also reducing the social impact of restructuring. “Some of these subsidiaries have become separate to such an extent that we have been able to sell them as independent companies and they’re operating very well on the market.”

These companies (and others that have already undergone an ownership transfer) also own such large chunks of land and such disproportionate infrastructure in comparison to their needs that they are often interesting as an investment partner rather than as a sheer take-over investment. At Puławy, Mr. Kwiatowski reminded us that “it is possible to subject melamine to further processing right here. We’ve got raw materials, sufficient energy supplies, our own power plant producing steam and electric current, we’re in possession of specialist terrain and we’ve got highly qualified personnel”. This is by no means an isolated case. A very significant investment in PET was just carried out by the Korean company SK Chemicals and this factor weighed in their decision. A company called SK Eurochem was created in conjunction with other partners. Mr. James B. Woo, CEO, explains: “We chose Anwil as our local partner because Poland was an environment we weren't familiar with but above all Anwil is operating on quite a limited portion of their territory and therefore they need foreign investors. They have huge supplies of utilities such as steam, gas, electricity and we need these energy supplies and at the same time we don't want to invest in producing these ourselves".

Another groundbreaking investment and partnership is the joint-venture that was created between Basell and PKN Orlen to produce polyolefins. The company, called BOP (Basell-Orlen Polyolefins) also draws on the feedstock that PKN Orlen produces and on other assets that relate to infrastructure belonging to PKN Orlen in Płock. SK Eurochem and BOP both provide for excellent examples of what the future could look like if the state provided for a clearer vision for the chemical industry.

PKN Orlen's take over of the Czech giant Unipetrol opens the door to even further steps by allowing for smoother cross-border cooperation and synergies for all involved. A good example of this is PKN Orlen's subsidiary Anwil. which is reaping benefits thanks to an association with Polana, a PVC producer which belonged to Unipetrol. Given its present position and dominance over feedstock for much of the commodity chemical industries, much will depend also on the attitude of PKN Orlen on the market. A little cynically, because they may compete in bids for state companies, PCC Rokita's President Mr. Krutin noted that "this is simply a fact that every investor operating in Poland has to be aware of and has to accept: a company has to cope with PKN Orlen somehow or else simply give up the idea of investing here." Nonetheless, if we are to believe Mr. Janus Wiśniewski, Vice President of PKN Orlen, this seems to bode well for the future as he expressed that it was Orlen's every intention to pursue its development not only in fuels but also in chemicals and to open themselves up to any profitable partnership that would allow them to grow in this sphere.

Poland's accession to the EU is the culmination of years of reforms and effort that have resulted in Poland becoming a stable and respected member of the union. The 'Wild East' has been tamed and the next round of investors in the Polish chemical sector will not be adventurous pioneers, but large established majors, and, following Septembers election, large stakes will be on offer. This stimulus should be enough to maintain the momentum of change for the chemical sector to see it through its next stage of development.

**Bright lights for a bright chemical future.
Soon in private hands?**