

FACING STRONG HEADWINDS

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HOUSING, CRUDE OIL, AND NATURAL GAS AFFLICT THE U.S. ADHESIVES AND SEALANTS INDUSTRY

The U.S. adhesive industry is facing strong headwinds halfway through 2008. The primary causes are the sustained drop in residential construction and the rapid rise in crude oil and natural gas prices during the first half of 2008.

At the beginning of 2008, The ChemQuest Group (CQ) expected growth to continue in 2008: up 4% in value and 1.5% in volume, driven by increasing applications in the fastening industry, for electronic devices, and medical applications. As for the sealant business, CQ predicted a decline in 2008 with value down 4.5% and volumes plunging 7% due to continued weak housing and construction markets. In actuality, the overall adhesive market is facing year on year volume declines as formulators are raising prices in an attempt to recover increasing raw material costs.

Housing

The U.S. housing market has continued its slide in 2008 with housing starts down 30% year over year to approximately one million units a year, a level not seen since 1991. The Federal Reserve's aggressive efforts to stem the subprime crisis through lower short-term interest rates has helped buyers with adjustable rate mortgages; but has had little effect on the long term rates with thirty year mortgage rates being what they were when the Fed began cutting in September of 2007.

Additional problems in housing include the growing number of lender owned properties as well as large inventories of existing homes for sale (11 months worth at current sales rates). Other factors include the increased cost of jumbo mortgages over conventional ones, tighter lending standards which lower the number pool of potential purchasers, and the number of would-be sellers who have yet to put their homes up for sale given the current market conditions. Efforts to backstop the real estate market are under consideration by Congress, but the crisis has so far been self-fulfilling in that as prices continue to decline at a faster rate, homeowners are likely to walk away or be foreclosed upon, thus pushing down prices even more.

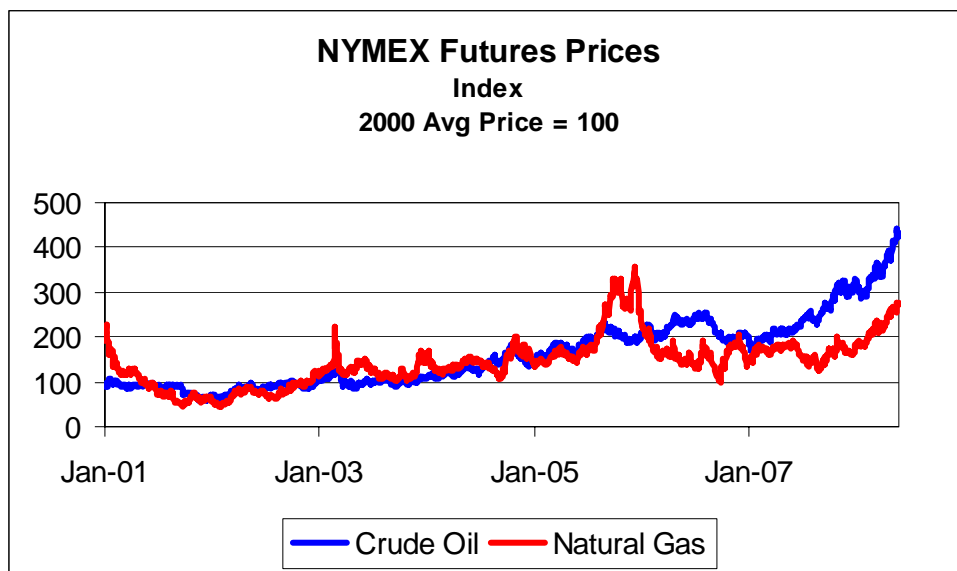


Crude Oil and Natural Gas

Historically, raw material costs for adhesive formulators are the largest component. These costs represent about 52%–60% of income (vs. 45%–49% in the coatings industry), and more than 80% of the cost of goods sold. This makes the industry particularly vulnerable to the negative effects of rising crude and natural gas prices. The continuing rise in crude and natural gas markets during the first half of 2008 have brought a wave of price hikes throughout the value chain as a number of resin producers announced price increases up to 20% this year.

As recently as December, 1998 crude oil traded at its historic low in real dollar terms (under \$10/barrel), in the aftermath of the Asian and Russian financial crisis. From 2001 – 2004, oil traded under \$40/barrel. In March, 2005 Goldman Sachs analyst, Arjun N. Murti, predicted that a “super spike” in crude oil with prices of \$105/barrel, a level few could envision prices rising to without a catastrophic supply disruption.

The chart below shows the relative change in pricing for crude oil and natural gas based on the average price for 2000.



How did oil get to its current price level so quickly without a major supply interruption? A number of explanations have been put forward including peak oil, the growing demand of China and India, environmental constraints on drilling, speculation, a lack



of refinery capacity, and the weakness of the U.S. dollar. The most plausible explanation is that the capacity to get crude oil out of the ground has not been able to keep up with the growing global demand from emerging markets, China in particular; resulting in very little excess global capacity should something disrupt a major/minor producer.

In addition to the rise in crude oil, natural gas prices in the U.S. have increased over 50% since the beginning of 2008 to nearly \$12 per million BTUs. Although, it is still below the historical highs reached in the aftermath of Hurricane Katrina in 2005. The market for natural gas has traditionally been regional but with the advent of a liquefied natural gas (LNG) infrastructure and the ability to ship product around the world, prices have become more uniform across regions. The result is that global pricing is moving towards a higher equilibrium pushing up the price for countries used to traditionally low natural gas prices like the United States.

As forecasters continue upward revisions to the average price per barrel, the futures market points to continued high prices for crude oil and natural gas into the next decade. If prices do stabilize at current levels, consumers may be able to adapt their behavior to use less, thus allowing new supplies to come on the market, but there remains a chance, as was shown in the 1970s that demand destruction will come quickly in the form of a recession.



About The Author



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The ChemQuest Group, Inc.,
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Todd joined The ChemQuest Group, Inc. in 1998 after receiving his MBA from Miami University in Oxford, Ohio. As Manager of Strategic Planning, he maintains up-to-date profiles on major industry participants as well as targeted value chains in the Coatings, Adhesives, and Sealants industries. He also holds a B.B.A. degree in Finance and Management from the University of Cincinnati.

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