

## European Investing Summit 2018 Preview: LafargeHolcim

*This article previews an idea presentation at European Investing Summit 2018. It is authored by MOI Global instructor Samuel Sebastian Weber, an independent wealth manager based in Zug, Switzerland.*

LafargeHolcim is the leading global construction materials and solutions company. Based on its targets for the next five years, the company trades at a discount to intrinsic value. Its current CEO has a strong track record of overdelivering on his targets, further strengthening the investment case.

### **Global Building Materials Industry and Competitive Dynamics**

Building materials is a fragmented CHF 2'500 billion market and is forecasted to grow 2-3% per year. Excluding China, the size of the market is CHF 1'750 billion, of which cement and ready-mix concrete amount to CHF 200 billion each and aggregates to CHF 220 billion. The other building materials market, representing 65% of the total, is valued at CHF 1'130 billion (LafargeHolcim, Investor Presentation, 2017).

Cement is a powdered mineral binder whose hydration produces durable solids. Nowadays, it is mostly used for production of concrete, being mixed with aggregates and water. Construction aggregates include sand, gravel and crushed stone, which are the dominant materials in concrete, accounting for 60% to 75% of the initial mix. Water and cement make up 15 to 20% and 10 to 15% of the initial mix, respectively. The production of aggregates, cement and concrete fluctuates with economic booms and downturns and, during building slumps, can contract rapidly and significantly. US cement consumption, for example, surpassed its 1973 high of 82 million tons only in 1986, and reached a new peak in 2005 with 128 million tons. Five years later, it dropped by 45% to just 71 million tons, a figure reached for the first time in 1968. In 1900 and 1928 those figures stood at 3 and 30 million tons, a 10\* increase in only 30 years (Vaclav Smil, Making the Modern World, 2013).

In their initial stage of development, countries need cement. At consecutive stages, the demand for aggregates and ready-mix concrete increases as building standards develop. Concrete (particularly its reinforced form) is now by far the most important manmade material both in terms of global annual production and cumulatively emplaced mass. Between 1945 and 2010, some 70 billion tons of cement were produced worldwide, and about 500 billion tons of concrete were integrated in structures, with 60% of the total put in place in the two decades between 1990 and 2010, and 35% between 2000 and 2010. Since 1986, global cement production has been dominated by China: During the 1980s Chinese cement output rose by 20%, during the 1990s it more than doubled, during the first decade of the twenty-first century it more than tripled to nearly 1.88 billion tons and in 2010 it accounted for about 55% of global output. In 2010, India produced 240 million tons, more than three times as much as the USA, with Brazil coming fourth (Vaclav Smil, Making the Modern World, 2013).

In the building materials market, products do not travel well due to significant transportation costs. Therefore, competitive dynamics are determined locally by supply and demand, input costs and competition. They differ materially between or even within countries and fluctuate

significantly over time. While some markets face structural oversupply issues, others remain undersupplied. The global trend is one of increasing volume demand, driven by the need to maintain huge infrastructures and a growing and aging population that increasingly lives in urban environments and big megacities and is getting used to better living standards.

### **LafargeHolcim and Its Competitive Advantages**

LafargeHolcim is the leading global construction materials and solutions company serving masons, builders, architects and engineers all over the world. The company produces cement, aggregates and ready-mix concrete which are used in building projects ranging from affordable, small, local housing to the biggest, most technically and architecturally challenging infrastructures. A new building project takes many years to complete, and customers usually work on multiple projects. Furthermore, different types of cement and aggregates are needed for specific mixtures. Lifelong partnerships and the requirement to adapt products to specific customer needs enable LafargeHolcim to build-up a reputation for reliability and quality.

In 2017, LafargeHolcim had a cement production capacity of 318 million tons and sold 229 million tons of cement, 279 million tons of aggregates and 51 million m<sup>3</sup> of ready-mix concrete with market shares, excluding China, of around 8%, 2% and 3%, respectively. It has approximately 80'000 employees in more than 80 countries, a portfolio that is equally balanced between developing and mature markets and broadly balanced across the world, with 5 regions contributing at least CHF 1 billion to its CHF 6 billion of EBITDA (LafargeHolcim, Investor Presentation, 2017). The small market shares show that the company, despite its size and its missing exposure to China, has much room to grow in each of its segments.

The total cement grinding capacity of 318 million tons is distributed around the globe: 117 million tons in Asia Pacific, 73 million tons in Europe, 39 million tons in Latin America, 55 million tons in Middle East Africa and 33 million tons in North America. India is the by far biggest market in the Asia Pacific region with a cement production capacity of 68 million tons. The world's biggest market, China, is clearly underrepresented with a capacity of "only" 11 million tons, despite being the group's 5th biggest country ranked by capacity. LafargeHolcim's capital intensive business model is reflected in its balance sheet, showing goodwill and intangible assets of more than CHF 15 billion, property plant and equipment of CHF 29 billion and total assets of CHF 60 billion (LafargeHolcim, Annual Report, 2017).

No other competitor has a comparable asset base, but most importantly, LafargeHolcim has very good regional market positions. It is number 1 in North America, number 2 in India and is among the top 3 suppliers in 80% of its markets, with no single market contributing more than 15% of its revenue. Its asset base, if used in an agile way, is one of the most important competitive advantages. Other advantages are: The ability to react to local market conditions using know-how to build many factories anywhere in the world, the ability to withstand local market downturns and spread best practices, secure access to raw materials, finance investments in IT and R&D, spread fix costs over a large number of produced tons and use its global distribution network and key account management systems to better serve customers.

The construction of a cement plant with a capacity of 1 million tons typically costs more than CHF 150 million. This represents around three years of sales, corresponding to an asset turnover of 30% (CEMBUREAU, Key Facts, 2017). Such a low turnover makes it very difficult for small local competitors to finance the investments needed to serve a growing local demand or withstand a prolonged local market downturn. LafargeHolcim's sales are almost as high as its fixed assets, corresponding to a turnover of 1. Due to its profitability, it can

allocate capital to the most attractive regions, strengthening its local competitive positions. And it can locally integrate its cement, aggregate and concrete businesses, further increasing the scale of operations.

For construction companies, which account for 40% of LafargeHolcim's revenues, roads, mines, ports, dams, data centres, stadiums, wind farms, and electric power plants are often complex projects. Building faster and more efficiently means increased productivity and additional business. Due to its large size, LafargeHolcim can fund research and development activities, creating innovative products and solutions that deliver more for customers and meet specific needs, and it can also invest to make sure that those products are reaching the markets by creating networks of professionally-trained partners. The company's international key account management team further supports major infrastructure players from the project design phase forward (LafargeHolcim, Annual Report, 2017).

Masons and individual homebuilders, which account for 60% of the company's revenues, need materials and solutions close to where they live and work. LafargeHolcim therefore has built a network of 1'000 Disensa stores across Latin America, more than 600 similar stores in the Middle East and Africa and is planning to further expand this concept to India and Southeast Asia. The vision is to offer self-builders and smaller contractors a one-stop shop that not only supplies its own and third-party materials but also supports them with microcredits, technical help as well as complete kits for different phases of home building (LafargeHolcim, Annual Report, 2017).

All of this explains the profitability of LafargeHolcim's operations. In 2017, its cement business generated recurring EBITDA of CHF 4'768 million on revenues of CHF 17'181 million, an EBITDA margin of 27.8%. The profitability of the aggregates and ready-mix concrete businesses lagged that of competitors, the former generating an EBITDA margin of 19% and the latter of only 6%. This substantial underperformance dragged down the average group EBITDA margin to 23%.

### **CEO and Management Culture**

According to a 2015 McKinsey study, the cement industry – LafargeHolcim's biggest business segment accounting for 65% of total revenues – has shown quite a strong return profile as expressed in total shareholder returns. From 1985 to 2015, the sector beat the MSCI market index with an average total shareholder return of 11% versus 9% per annum. However, all five large multiregional players belonged to the bottom quintile of companies, substantially underperforming regional players. The study identified overspending on capital expenditures and acquisitions as the main factors explaining the comparative underperformance of multiregional players. Trust in management, therefore, must be a key-pillar of this investment thesis.

Jan Jenisch took on the CEO role on September 1st, 2017. He is a very hands-on manager focused on execution, spending two-thirds of his working time on production sites or travelling to them. Soon after starting his job, he took impairment charges of CHF 1.7 billion on property, plant and equipment and CHF 1.8 billion on goodwill and implemented major changes to fundamental business processes. His overall aim is to increase the return on invested capital to more than 8% until 2022, implying profits of at least CHF 3.5 billion on current invested capital of CHF 43.6 billion. Within a few months, Jenisch reduced the executive committee from nine to eight members, replaced six of those members and eliminated a whole management level of 20 people. The 35 biggest markets now report directly to group management. Furthermore, he closed the subsidiaries in Singapore and

Miami, reasoning that managers should spend time at the production sites instead of headquarters, and promised to implement similar changes on regional and country levels. He also terminated ongoing projects with McKinsey and BCG, arguing that internal employees should develop business concepts, not external consultancies. He did not sign the standard international employment contract that was negotiated with employee representatives by his predecessors but instead replaced it with specific local agreements (Bilanz, Der Bulldozer, 2018). Overall, the company aims to improve its operating efficiency and reduce selling, general and administrative expenses by CHF 400 million per annum from Q2 2019 on.

Business decision processes and reporting have been dramatically simplified. Local markets were empowered and made fully profit and loss accountable to better reflect the local nature of the business, increasing transparency and fairness throughout the organization. The two headquarters in Paris and Zurich were shut down and moved to a new office in Zug, Switzerland, reducing the headquarters' size by more than 80%. Pricing decisions are delegated to local management who knows most about local business conditions. The previous 40 to 50 key performance indicators were reduced to four – growth, cash conversion, operational profit and capital returns – reducing the size of monthly reports from 140 to five pages (Bilanz, Der Bulldozer, 2018).

Importantly, capital allocation will be focused on the most promising regions and projects, while the aggregates and ready-mix concrete business will be improved operationally to close the performance gap with competitors. Growth will be funded through the divestment of selected assets in 2019 worth at least CHF 2 billion, excess free cash flow will be used to pay an attractive dividend and capex will be kept below CHF 2 billion per annum (LafargeHolcim, Annual Report, 2017). The increasing importance of the aggregates and concrete businesses in the group's profitability will reduce overall capital intensity. Out of capital expenditures of CHF 1'387 million in 2017, the cement business consumed CHF 1'134 million. The aggregates business consumed less than CHF 170 million of capex, even though it sold 279 million tons compared to 229 million tons of cement and employed 650 plants compared to 220 cement plants. The ready-mix concrete business employed over 1'400 plants, consuming less than CHF 80 million of capex.

Agile, country-based growth strategies will target value-enhancing bolt-on acquisitions to leverage scale and margins. This year alone, LafargeHolcim made four such acquisitions, compared with zero in the past 5 years. A newly created fourth business segment, Solutions & Products, which currently includes precast, concrete products, asphalt, mortars and contracting and services, generates net sales of CHF 2.1 billion and is expected to grow to CHF 4 billion until 2022 (Bilanz, Der Bulldozer, 2018). This segment reflects an attempt to go closer to customers and provide them with products and solutions where the value provided, not the competitive situations, determines the price that can be asked from customers.

Due to the local nature of its businesses and the different stages of the building cycle they go through at any given point in time, LafargeHolcim is in a constant battle to use its global scale advantages while maintaining local agility. Given Jenisch's track record at Sika and the very similar business challenges the two companies face, the chances are very high that he will manage those trade-offs well. Furthermore, Jenisch has a very strong track record of overdelivering on his targets. During his five years as CEO of Sika, he revised his targets upwards twice and increased revenues by 26% and profits by 230%.

## **Valuation**

In 2017, LafargeHolcim generated more than CHF 26 billion of revenues and almost CHF 6

billion of recurring EBITDA. The company plans to grow those figures by 3-5% and more than 5% per year, respectively. It further aims to generate a ratio of free cash flow to recurring EBITDA of at least 40%, implying significant operational improvements.

If the company reaches those targets, it will generate recurring EBITDA of more than CHF 7.6 billion and recurring free cash flow of at least CHF 3 billion in 2022. As free cash flow includes both growth and maintenance capex, it understates the company's true earnings. The investments needed to maintain the status-quo are shown in the footnotes of the annual report and based on these figures, LafargeHolcim's true earning power will be around CHF 4 billion in 2022.

Applying a P/E multiple of 15 shows an intrinsic value of CHF 60 billion or CHF 41 billion discounted back to today with a discount rate of 8%. This looks very attractive compared with a market cap of less than CHF 30 billion, even more so when considering the attractive dividend yield of 4%, and should compensate investors for the significant profit shares of minority shareholders.

At the end of 2017, the company had debt of almost CHF 19 billion on which it paid an average weighted interest rate of 4.5%. The interest payments were comfortably covered by EBITDA and fixed rate liabilities made up almost 70% of the total, limiting the risk of sudden rate increases. Current financial liabilities of CHF 3,843 million were comfortably covered by existing cash, cash equivalents and unused committed credit lines. Future maturities will decrease significantly after 2018.

Concerning FX risk, 10.8% of the company's debts were in CHF, 40% in EUR and 28% in USD. As a large part of the foreign capital is financed with matching transactions in local currency, the effects of the foreign currency translation on local balance sheets for the consolidated statement of financial position have not, in general, resulted in significant distortions in the consolidated balance sheet (LafargeHolcim, Annual Report, 2017).