Solid Prospects for Cementir

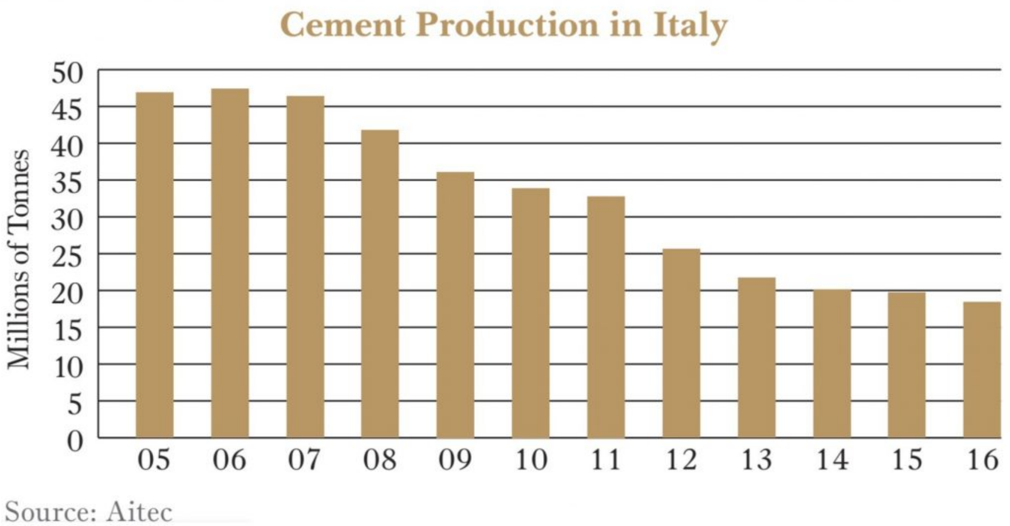
If you have visited Rome, you might wonder how so many temples, bridges and aqueducts constructed during Roman times are still standing. Cement, a mix of crushed limestone, clay and volcanic ash provides the answer. When mixed with water, cement gives strength and durability to concrete.

Nearly 2,000 years have passed and this 'Roman recipe' has hardly changed. Cement has become a huge industry. Consumption globally stands at nearly 4 billion tonnes annually and cement makers generate more than US$250 billion a year in sales.

Industry Structure Matters Most

Big business doesn't necessarily mean good business for shareholders, though. Due to volatile end-demand, high fixed costs and capital intensity, the cyclical swings can be enormous. And even if one takes a whole-of-cycle view, cement manufacturing can be either a terrible or a wonderful business. The difference all comes down to local industry structure.

Italy is one place where cement manufacturing has been rather terrible. As you can see in the accompanying chart, following the financial crisis Italian cement production (a proxy for demand) has decreased from 48 million tonnes in 2006 to only 18 million in 2016 – a 63% drop. That's the cyclical part.



But there's also the structural part. There are more than 15 cement makers in Italy. The majority of these own just one or two plants. A reduction in industry-wide capacity is the key to improving the economics of the overall industry. But when taken singularly, the incentive for industry players is to do the exact opposite. If they can cover their fixed costs, it makes sense for them to continue to produce while waiting for the market to recover.

With so many players, industry rationalisation had proven elusive. Over the last decade annual capacity has fallen to about 30 million tonnes as older plants have been mothballed. But that's not enough in a market where demand is below 20 million tonnes. All cement businesses are still struggling to turn a profit. Rome-based **Cementir** (BIT: CEM) is one such business and one of the Fund's most recent investments. In Italy last year, Cementir generated €120m in revenue and operating losses of €20m.

Why have we bought a cement maker operating in a market with such crappy economics?

The Value in Cementir

The first reason is Cementir's operations outside Italy dwarf its domestic business. And some of those operations are in nations and markets where it benefits from much better industry structures. Setting up a cement plant requires significant upfront costs. Annual production capacity of one million tonnes requires about US$200m of upfront investment. Also, cement is a commodity product where price matters most so manufacturing scale and efficiency are paramount. Cement is also heavy and costly to transport. So it makes sense to produce it in large plants located close to both limestone quarries (a key input) and customers.

For these reasons, once a cement business becomes established in a region, it's hard to steal its business. Cementir is the only cement manufacturer in Denmark, for example, where it has an 82% market share. Sales and operating profits in this region have averaged nearly €300m and €50m respectively over the past decade. Return on capital has averaged 12%.

The company also has operations in Sweden, Norway, Belgium, Turkey, Egypt, Malaysia and China. So despite being listed in Italy, it is mostly exposed to other economies with less fragmented local cement industries. Less than 15% of the Group's €1.1 billion of sales belong to the troubled Italian operations.

The other reason for our interest in Cementir is that the Italian market is finally making some moves towards consolidation, and perhaps better economics for remaining participants. In 2015 **Heidelberg** (DB: HEI) acquired Italcementi, the leading Italian cement company. Recently, Cementir acquired Sacci and **Buzzi Unicem** (BIT: BZU) acquired Cementi Zillo. This wave of consolidation should help improve the industry structure. If the company can just break even in Italy it will add meaningfully to profitability. It should do better than that if Italian demand recovers modestly, which is a decent bet. Turnaround potential also exists in the operations in Turkey and Egypt.

Currently Cementir has a market capitalisation of €830m. Its cement businesses should earn circa €80m in net profits in 2017, after carrying the burden of loses in Italy. This implies that the group is trading on a price to earnings ratio of about 10 times. This looks cheap considering that the current level of profitability should improve in the future. The stock is up 15% on the Fund's average purchase price, and represents 3.5% of the Fund's assets.

This blog post is an updated extract from our June 2017 quarterly report – if you would like to be added to the distribution list, please sign up here.