INTERCEM®

EST. 1985

Distributed at INTERCEM 100, Istanbul

24TH –26TH JUNE

CEMENT, A FOUNDATION FOR MODERN SOCIETY

A collection of essays and recollections on the occasion of INTERCEM 100

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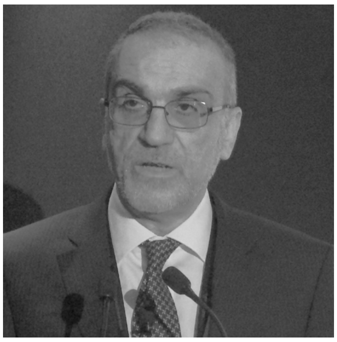

Does Global Consolidation Confer Scale Benefits In The Cement Sector?

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DOES GLOBAL CONSOLIDATION CONFER SCALE BENEFITS IN THE CEMENT SECTOR?

Does global consolidation exist? Does it work?

The first thing to consider is the global consolidation theme. Has this materialised? In 2012 it was estimated that the top seven cement producers held around 16% of global cement capacity. By 2016, the share of the top seven had dropped to 15%. So, in analytical terms, global consolidation did not actually come to pass following the earlier mega-mergers and transactions. However, this begs the question of whether this is the correct way to approach the consolidation argument.

It is now accepted that the “global consolidation” argument does not bear scrutiny when it comes to how it is reflected in the financial performance of the consolidators (mainly major international cement companies). Synergies did not materialise, and their expanded footprint hindered rather than facilitated further growth. There have been several analytical reports on these issues by various cement industry observers.

However, there is also a more fundamental argument that supports this view; most cement professionals instinctively understand that economies of scale in this industry are mainly applicable at the plant level. Several studies from major consulting groups have attested to that.

CBA has also undertaken its own research and analysis in this area and our findings are stark. We have found that not only are economies of scale mainly applicable at the plant level, but also that the most lucrative economic locus of a cement plant is 200-300 km around its chimney. We have indeed confirmed this golden “rule of thumb” in our industry.

Furthermore, our work on Micro-Market Attractiveness Matrix (MAM™) coupled with our Capacity Concentration Balance Index (CCBI™) indicate that the location of the plant relative to up and coming local markets and the industry concentration in its locality are the most important variables in determining the financial performance of a cement business (assuming the cost structure is on par with competitors). In other words, financial health in cement is dependent on local conditions and not on the global scene.

How would a subsidiary of a major cement company in Egypt benefit from global consolidation, when in the last few years it has experienced an avalanche of capacity additions whilst the fragmentation of the industry remained high? The answer to this question is: not at all. Indeed, the Egyptian financial results bear this out. Egypt is not unique in this regard; it is one example of the recent path followed by many emerging markets.

How did we get to this point?

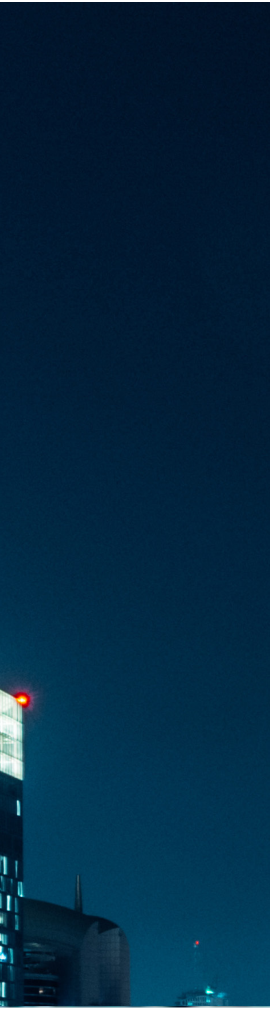
We do not argue that cement companies should only operate one plant in one location. Growth is an inherent part of every business. A successful business will want to, and indeed should, grow. And this is how the decades-long expansionary strategy of the major companies has developed. Most have started from their own micro-market. For example, Lafarge from France, Holcim from Switzerland, CRH from Ireland, CEMEX from Mexico and so on.

It was in those markets that these companies became successful and honed their cement operating skills and capabilities. And then naturally they sought to apply those skills on a larger footprint. Hence the expansionary strategy of the last decades and their investments in most of the major cement markets in the world. This, coupled with two other fundamental conditions, has supported these companies in their expansionary strategy.

The other two fundamental conditions were:

- The belief that geographic diversification, particularly in emerging markets where cyclicality was not an issue, would protect the major companies from their developed markets' notoriously cyclical behaviour

- The high level of growth expected in emerging markets, coupled with the lack of indigenous cement players.



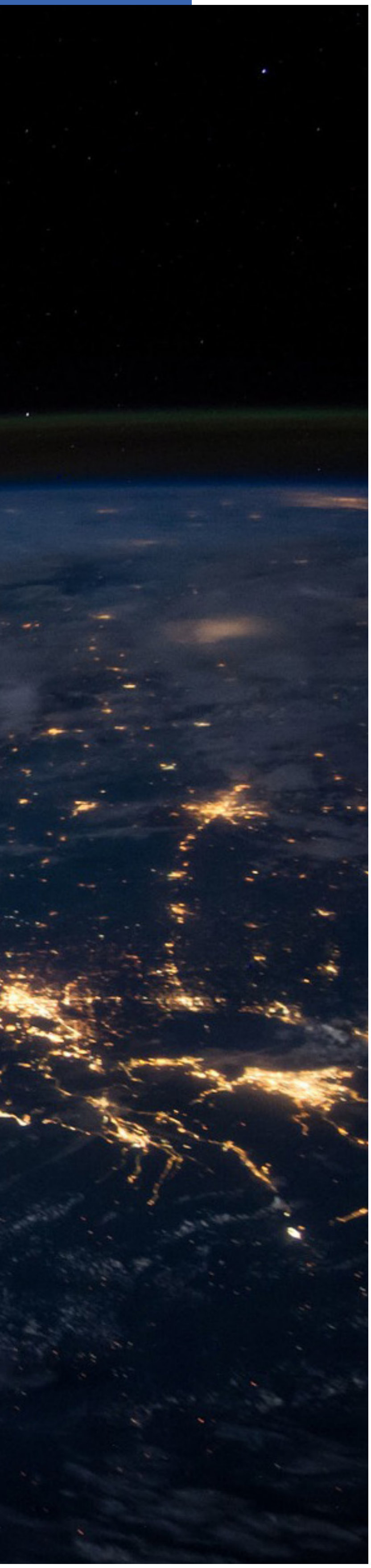
Those two conditions were valid until around the turn of the twenty-first century when they began to dissipate.

Facing the reversal of these two fundamental conditions, major players in the industry embarked on what might be described as a "cannibalistic" behaviour—devouring each other in the name of global consolidation. There are many examples of this, some of the outstanding ones are listed here: Lafarge acquired Blue Circle Industries plc; CEMEX acquired RMC plc; Holcim acquired Aggregate Industries plc; Heidelberg acquired Hanson plc; Lafarge and Holcim merged; CRH acquired the disposed assets stemming from LafargeHolcim's merger; and Heidelberg acquired Italcementi. This activity began at the turn of the twenty-first century and ended around fifteen years later.

Was there an alternative?

Based on the previous assertion of the local nature of the industry, it is evident that the major companies could have adopted a different strategy. It is reasonable to assume that pursuing a strategy of consolidating individual markets whilst at the same time seeking a low-cost position, would have yielded a stronger value-creation opportunity. This strategy is very similar to that used by CRH before it embarked on a changed business model. However, this would have been a painstaking and long-term process that inevitably would not satisfy managements' voracious appetite for quick growth, nor would it have supported their quest for globalisation.

In their communication with their shareholders, the majors appeared to present the number of countries they operated in and their share of global cement capacity as an indication of strategic and financial prowess. Critics suggest that the majors employed a "never mind the quality, look at the size!" approach. At the same time, they touted the "synergies" and other benefits they believed attributable to their recent globalisation efforts.



Many complain that it is quite unnerving to witness such misguided behaviour from some of our industry's most illustrious names. Particularly as, in the last ten years, our sector has been facing some very challenging issues. There may be some fundamental management issues at play, but they will not be explored here.

Unwinding of globalisation

Recently, we hear a lot about major cement producers selling various operations across the world. We have seen some concrete action in this area: the sale of LafargeHolcim Indonesia; the very recently announced agreed disposal of the entire 51% shareholding of LafargeHolcim in Lafarge Malaysia

Berhad; and the reduction of Heidelberg's stake in Ciments du Maroc are some examples. But also, there are lots of rumours/ announcements about further disposals: LafargeHolcim Philippines; LafargeHolcim African assets; CEMEX selling some European assets to Schwenk; and CRH's potential disposals on many fronts as shareholders appear to be seeking a more streamlined business.

So, it seems that we are experiencing a move towards selling cement assets, mainly in developing or emerging markets by some of the largest international cement companies. To make things more complicated we have now seen the entry of an activist investor in CRH's shareholders ranks and significant changes at the top of HeidelbergCement.

Could it be that the major cement companies have realised that globalisation does not necessarily offer the best value creation opportunity? Could it be that shareholders have also come to this conclusion—driving a shift to more streamlined and less diverse businesses? Should we expect the major companies to shrink in size?

It seems that we are at a point in time where old trends are passing away, and the new trends are not yet clear. What is clear, is that the industry continues to develop and shift in response to many forces—not all of which are commercial.

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