Industry Top Trends 2016
Building Materials

BUILDING MATERIALS GAIN TRACTION


- **Operating Performance.** We expect the sector’s operating performance to improve due to increased new home construction and remodeling activity as well as an expected uptick in commercial activity, particularly in the U.S. Further economic recovery in Europe should also add to recent positive trends there. These factors will likely help boost the earnings and cash flows of most companies in the sector.

- **Credit Metrics.** Increased cash flows and earnings in 2016 should result in further improvements in debt to EBITDA and other leverage ratios as EBITDA continues to grow, but we do not expect large debt repayments. Increased share repurchases and acquisition activity could follow as the sector gets further into a recovery stage.

- **Risks.** The potential risks we see for the industry include a significant shortfall in expected U.S. housing starts of 1.3 million for 2016, global contagion of regional recessions spreading to recovering U.S. and European economies, quickly rising interest rates hindering mortgage and refinance activity, and lower government revenues for public spending in Latin America.

- **Industry Trends.** We see a trend of further acquisitions and consolidation in the industry, particularly among building materials distributors. Private equity has been particularly active in pursuing mergers and acquisitions (M&A) in the sector.

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GLOBAL BUILDING MATERIALS RATINGS DISTRIBUTION AND OUTLOOK

There are a high number of ratings in the 'B' category due to the large number of smaller highly leveraged issuers owned by financial sponsors.

Overall, ratings are predominately stable as the sector remains in the early stages of a cyclical recovery.

While sector fundamentals are positive, ratings upside is constrained by a large number of highly leveraged issuers owned by financial sponsors.

Source: S&P Ratings
We expect 3%-6% growth in most markets as construction markets in the US and Europe continue their slow recovery. Higher EBITDA margins will be driven by increased operating leverage as volumes improve and commodity costs stay low.

Increased EBITDA (as opposed to debt repayment) will drive improved credit metrics.

Although the majority of our ratings have stable outlooks, there is a growing positive bias. This is largely due to improving construction and remodeling markets in the U.S. and a continuing recovery in Europe. We forecast housing starts to grow to 1.3 million units (up 200,000) in the U.S. in 2016, and we expect repair and remodeling spending to grow in the mid-to-high single digits. This should result in the best operating performance for North American building materials companies since the downturn that began in 2007.

We expect credit measures to improve as a result, but the large number of highly leveraged financial sponsor-owned companies among the issuers we rate will constrain the number of upgrades.
**ASSUMPTIONS**

### NORTH AMERICA

<table>
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<th>Positive Volume Growth</th>
<th>Uneven Growth Factors</th>
<th>Further Consolidation</th>
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<td>1</td>
<td>Most macroeconomic indicators that affect the sector, such as GDP, also point to continued growth over the coming 12 months. In the U.S. we expect new housing starts of about 1.3 million; commercial construction to grow by 5.9%, and repair and remodel spending to increase in the mid- to high-single digits in 2016. In Canada, we project about 200 thousand housing starts but overall building materials demand will be flat to down due to weak economic conditions in the oil-producing provinces.</td>
<td>A relatively high percentage of new homes in the U.S. are multifamily dwellings, accounting for 36% of housing starts in 2014, compared with the 25-year average of 22%. Multifamily housing starts typically require less material per unit and are lower yielding for building materials companies than single-family homes. Moreover, multifamily units generally use less expensive finishing materials than single-family homes.</td>
<td>We expect to see the trend of increased private equity participation in the space to continue, and possibly even accelerate. We also expect to see an increase in private equity sales or IPOs as a number of financial sponsors in the sector have held investments for five, seven, and even 10 years and look to exit.</td>
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### EMEA

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<th>A More Favorable Revenue Trend</th>
<th>Key Markets Lagging Behind</th>
<th>Margin Improvement</th>
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<tr>
<td>1</td>
<td>We expect a CAGR revenue growth of about 2%-4% in euro terms from 2016 to 2018 in EMEA on average, driven by a recovery in volumes and a flat to slightly improving pricing environment. We expect a continuation of the moderately positive trend in construction confidence in a number of geographies in continental Europe to support an increase in demand for building materials products.</td>
<td>Still, a number of markets lag behind in terms of recovery. Some of the most prominent markets, like France and Italy, still present signs of weakness, while others like Egypt or Russia could be facing accrued risks. In particular, France is suffering from a fragile and still depressed residential market despite government incentives. Italy, most likely, will have bottomed out in late 2015, but the path of recovery is likely to be moderate due to a rather fragmented market offer which may prejudice the prospects for cement price recovery.</td>
<td>We expect European building material producers will be able to improve EBITDA margins progressively over the next three years, thanks to revenue growth and the benefits from restructuring undertaken over the past few years. We believe that the low inflation environment that prevails across Europe will limit producers’ ability to implement/pass through price increases on a sustained basis. However, companies are benefiting from the current low oil price, which has significantly helped ease cost inflation.</td>
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### LATIN AMERICA

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<th>Revenues Driven by Housing &amp; Infrastructure</th>
<th>Brazil Will Remain Challenged</th>
<th>Infrastructure Spending Will Drive Cement In The Region</th>
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<td>1</td>
<td>Demand for building materials in Latin America remains mostly driven by a significant housing and infrastructure deficit. Demand for building materials will follow local trends of housing growth and government investment in public works. As a result, we expect rating trends to vary among the countries but in the region overall will largely remain stable.</td>
<td>Brazil is the only country that faces a negative rating trend as we expect a high single digit contraction in volume sales in 2016. High levels of inflation, increasing unemployment rates and lower credit availability are putting significant pressure on household income and therefore spending for housing construction and improvements.</td>
<td>We expect mid-single digit growth in Mexico’s building materials industry where the market is benefitting from double digit growth in housing. Also, government efforts to pursue a national infrastructure program could add to positive growth in that sector. Columbia, Panama and Peru have shown recent signs of a moderate economic recovery which we think will add to government investment in public works there, helping local cement producers.</td>
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### Key Industry Risks and Opportunities

#### North America

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<tr>
<th><strong>1</strong></th>
<th><strong>Housing Starts May Fall Short</strong></th>
<th><strong>2</strong></th>
<th><strong>Higher Interest Rates</strong></th>
<th><strong>3</strong></th>
<th><strong>Infrastructure Investment</strong></th>
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<td>Risk of lower than expected housing starts and consumer confidence due to bad weather or global recessionary pressures spreading to the U.S. Longer-term fundamentals for U.S. housing growth remain favorable due to strong population growth and household formation.</td>
<td>A rapid rise in interest rates could put downward pressure on mortgage volumes and slow new and existing home sales, subsequently hampering sales volumes for building materials companies.</td>
<td>We see the opportunity for further industry growth in infrastructure spending given the recent agreement in Congress to authorize a new five-year highway bill. We expect further spending at state and local levels because there is general agreement among private and public officials on the need for massive investment in infrastructure over the next decade. Individual states have already increased their capital spending on roads and transportation because of flat federal spending.</td>
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#### EMEA

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<th><strong>1</strong></th>
<th><strong>Slowdown In Emerging Markets</strong></th>
<th><strong>2</strong></th>
<th><strong>Abrupt Rebound In Oil Prices</strong></th>
<th><strong>3</strong></th>
<th><strong>Capex Reductions</strong></th>
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<td>Risk of a further economic slowdown across several regions including Asia Pacific and Latin America could have an impact for European producers with geographical presence there, reducing growth ambitions and margins. The subdued growth observed in China could also contaminate peripheral Asian markets.</td>
<td>Risk of an unforeseen abrupt rebound in oil prices from the current low level. This would have hurt industry profit margins, as it would be challenging for producers to successfully pass on cost increases to end users.</td>
<td>A cut in capital expenditure following integration of acquisitions could bring some relief to issuers’ credit ratios. This is particularly the case for the largest cement producers who engaged in sizeable M&amp;A activity and who are likely to focus more on integration in the near term, instead of pursuing expansionary projects.</td>
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#### Latin America

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<th><strong>1</strong></th>
<th><strong>Low Oil Prices</strong></th>
<th><strong>2</strong></th>
<th><strong>Lower Than Expected Economic Growth</strong></th>
<th><strong>3</strong></th>
<th><strong>Corruption And Government Cutbacks Impact Infra Spending</strong></th>
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<td>Sustained low oil prices will have a detrimental impact on government revenues in Mexico, resulting in less funds available for infrastructure spending and thereby reducing cement demand and construction activity.</td>
<td>Weaker than expected macroeconomic conditions in the region’s largest markets, Mexico and Brazil, would affect household income and consumption preferences related to housing construction.</td>
<td>In Mexico, a 20% cut in the government’s budget for infrastructure assets could delay the execution of projects in key sectors such as roads, airports, port construction, and energy. Also, corruption investigations in Brazil impacting some of the largest engineering and construction conglomerates could delay infrastructure projects, while the potential of fiscal constraints in Columbia, Peru and Panama could slow public projects.</td>
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INDUSTRY DEVELOPMENTS

North America

We expect more investment from Financial Sponsors and more IPO’s

We expect private equity firms to continue to invest in the building materials sector as it is still viewed to be in the early- to mid-stage of a cyclical recovery. Therefore, we expect more acquisitions and mergers among smaller players in the sector, as well as more IPO’s of companies that have been held by private equity for over five years.

EMEA

Further consolidation in cement and some scaling back on expansion projects

Following the heavyweight merger of Holcim and Lafarge, and asset divestments from these former groups to CRH, we are seeing further industry consolidation in the European cement market. In July 2015 HeidelbergCement announced the acquisition of Italcementi, to be completed in 2016, creating the second largest global player. In the same sector, some small players could merge or absorb assets from distressed companies, especially in the more fragmented markets like Italy for instance. We see consolidation not only in cement markets but also in other niche and specialty areas.

The consolidation could bring more pricing discipline and contribute to reducing, modestly, the supply and demand imbalance in some cement markets. We anticipate that future acquisitions could continue to involve asset divestments or asset swaps, not only to satisfy competition authorities’ requirements, but also to alleviate part of the impact of debt-funded acquisitions. Additionally, for the largest cement producers who engaged in sizeable M&A activity, we see an opportunity to focus on delivering synergies by temporarily prioritizing integration over internal expansion projects, with a scaling back in capital expenditure being one consequence. Given the weight of the top cement producers in the EMEA building materials portfolio, we see overall capex reducing over the next two years in Europe. To some extent this should contribute to an improvement in margins, in addition to continued cost reduction programs combined with the positive effects from past restructuring actions.

Still, we view the effects of consolidation on credit quality of the sector as mixed so far. In some instances, divestments were made, partly counterbalancing additional indebtedness incurred in the M&A process. The merger between Holcim and Lafarge was largely credit neutral to positive for the combined entity. Lafarge’s credit profile has improved following the merger with Holcim, leading to a deleveraging to the level of the Swiss company. We have also revised Italcementi’s outlook to positive, as its merger with HeidelbergCement will likely result in a more diversified and less leveraged combined group. On the contrary, we have revised our outlook on CRH to negative as the accumulation of debt-funded purchases led to higher financial leverage, despite a reinforcement of its revenue footprint and vertical integration.

FINANCIAL POLICY

North America

We expect private equity firms to continue to invest in the building materials sector as it is still viewed to be in early-mid stages of a cyclical recovery. Therefore, we expect more acquisitions and mergers among smaller players in the sector, as well as more IPO’s of companies that have been held by private equity for over five years. Among investment grade names, as earnings continue to improve and debt leverage decreases, we expect to see an increase in share repurchases as firms return excess cash to shareholders.
GLOBAL BUILDING MATERIALS: CASH, DEBT AND RETURNS

CHART 11 | CASH & EQUIVALENTS / TOTAL ASSETS

Global Building Materials - Cash & Equivalents/Total Assets (%)

CHART 12 | TOTAL DEBT / TOTAL ASSETS

Global Building Materials - Total Debt / Total Assets (%)

CHART 13 | FIXED VS VARIABLE RATE EXPOSURE

Variable Rate Debt (% of Identifiable Total)
Fixed Rate Debt (% of Identifiable Total)

CHART 14 | LONG TERM DEBT TERM-STRUCTURE

LT Debt Due 1 Yr
LT Debt Due 2 Yr
LT Debt Due 3 Yr
LT Debt Due 4 Yr
LT Debt Due 5+ Yr
Nominal Due In 1 Yr

CHART 15 | CASH FLOW AND PRIMARY USES

Capex
Net Acquisitions
Dividends
Share Buybacks
Operating CF

CHART 16 | RETURN ON CAPITAL EMPLOYED

Global Building Materials - Return On Capital (%)

Source: S&P Capital IQ, S&P Ratings calculations
RELATED RESEARCH

- Conditions Are Ripe For Stronger Growth In The U.S. Building Materials Sector, October 20, 2015

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