Industry Top Trends 2017
Building Materials

Overview

– **Ratings Outlook**: Rating trends across the building materials industry remain mostly stable with an overall neutral bias, Asia-Pacific (APAC) excepted which displayed a negative trend over 2016. Still, positive momentum in the U.S. and the moderately recovering construction industry in Europe support mid-single-digit growth in those regions.

– **Forecasts**: Credit ratios are likely to improve modestly in 2017, reflecting improving operating leverage and moderately positive price movement. We believe that energy cost increases will limit further significant progress in margins.

– **Assumptions**: We still assume improvement in macroeconomic fundamentals in North America, with margin improvement across the board, notwithstanding increased energy prices and higher interest rates. In Europe, Middle East, and Asia (EMEA), we project a modest industry recovery, but any improvement in margins will likely be constrained due to still-tight price conditions and increased energy prices. In Latin America (Latam), we assume soft volume sales and still-leveraged capital structures. In APAC, we assume mild demand recovery and price stabilization; we also believe that debt reduction in the region will exceed cash flow improvement, as a result of trimmed investments.

– **Risks**: Overcapacity is still the major risk we see in the regions, with the exception of the U.S. In the U.S. and EMEA, we also see a risk of a relaxation of financial discipline, which could result in share repurchases or increased dividends. At the regional level, we also see risks related to an accelerated interest rate increase in the U.S., soft economic conditions in LATAM, and currency and raw material cost volatility in APAC. In the U.S., other risks include the uncertainty of future U.S. government policies regarding possible tax code changes, deductibility of interest expense for business, and the possibility of trade frictions that could make imports more expensive, dampening U.S. growth and slowing housing starts and construction activity as a result. Strict immigration controls could also exacerbate an already-tight labor market for construction.

– **Industry Trends**: We forecast further consolidation, particularly in the cement industry and, in the U.S., small regional manufacturers and distributors. Also, companies have trimmed investments in those regions with overcapacity, which may result in lower price pressure in the next couple of years. In most healthy regions, namely the U.S., we believe that companies will use cash flow to support growth or to return more funds to shareholders.
Ratings trends and outlook

Global Building Materials

Chart 1 – Ratings distribution

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.

Chart 2 – Ratings distribution by region

North America and, to some extent, western Europe, have the largest number of 'B' category ratings due to the prevalence of financial sponsor and private equity investment in the sector.

Chart 3 – Ratings outlooks

Overall, ratings are predominantly stable, because the sector is in the recovery phase in both Europe and North America. Rating upside is limited, notwithstanding positive sector fundamentals in the U.S. and Europe, because of highly leveraged issuers owned by private equity.

Chart 4 – Ratings outlooks by region

We see a prevalence of negative outlooks in the LATAM and APAC regions, reflecting overall weaker macroeconomic conditions and significant overcapacity compared with North America and Europe, of highly leveraged issuers owned by private equity.

Chart 5 – Ratings Outlook Net Bias

An overall stable and balanced outlook bias masks some divergence in the regions, with a worsening trend in the APAC and LATAM regions and a modestly improving trend in Europe.

Chart 6 – Ratings Net Outlook Bias By Region

Source: S&P Global Ratings. Ratings data measured quarterly with last shown quarter ending December 31, 2016
Industry forecasts

Global Building Materials

Chart 7 – Revenue growth (local currency)

We expect mid-single-digit growth in most regions, with the exception of the APAC region.

Chart 8 – EBITDA margin (adjusted)

Overall modestly improving margins reflect increased operating leverage that offsets some recovery in energy prices.

Chart 9 – Debt / EBITDA (adjusted)

Increased EBITDA and capital expenditure optimization drive the improvement in leverage. For investment grade companies, we expect debt repayment to be less than 2016, and instead we believe companies may undertake acquisitions or increase shareholder remuneration. For financial sponsor-owned companies, we expect little change in leverage, because these companies should continue seeking out acquisitions or eventually pay dividends.

Chart 10 – FFO / Debt (adjusted)

Source: S&P Global Ratings. Revenue growth shows local currency growth weighted by prior-year common-currency revenue-share. All other figures are converted into U.S. Dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate.
### Key assumptions

#### North America

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<th>1</th>
<th>Improvement in macroeconomic fundamentals</th>
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<td>In the U.S., we expect 2.4% real GDP growth, 4.6% unemployment, and 1.3 million housing starts for 2017. We further expect mid-to-high-single-digit growth in repair and remodel activity, continued choppy commercial construction activity, and steady to slightly elevated infrastructure spending due to stronger state budgets. Even in the event a large increase in infrastructure investment is put forth by the U.S. government, the benefit of such a program would not likely be felt until 2018 because it will take a year for projects to be identified and bid before monies are actually spent.</td>
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<th>Flat-to-increased commodity costs, increased interest rates</th>
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<td>We expect commodity costs to rise modestly in the coming year(s), coming off of current low levels. While energy/oil-related costs have increased some as of late, they are still well below their 2014 and 2015 levels. We expect the impact to be slight overall, since many companies seem to have already implemented systems and cut costs in other areas and are now in a better position to accommodate commodity inflation. We also believe that interest rates will rise in 2017 and 2018, specifically that the Federal Reserve will raise interest rates three times in each year. Over the next 12 months we expect this to trigger refinancings, even for companies with maturities longer than three/four years.</td>
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<td>As overall pricing environments continue to improve, we expect to see further margin expansion for many of our issuers, but not as robust as 2016. We do believe this trend will improve cash flow generation and provide companies the opportunity to improve balance sheets via debt repayments or capital improvements. Along those lines, we believe improving operating performance of companies will help keep—if not hasten—the pace of merger and acquisition activity in the building materials sector as acquirers seek opportunities to consolidate competition in certain fragmented segments (e.g., distribution, windows) or to improve geographic diversification or add to product lines. We expect such activity to be more pronounced among investment-grade issuers, but we do expect speculative-grade names (especially those owned by private equity) to consolidate in several subsectors such as windows and distributors. Possibly slowing this trend down is the prospect of an increased purchase multiple for targets in the sector.</td>
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**EMEA**

1. **2017 to be another steady year**
   
   Our forecasts suggest that in 2017 the eurozone construction sector will continue to follow a rather modest recovery path, but other markets that are important for some EMEA issuers, such as Turkey, South Africa, and Russia will remain sensitive to geopolitical risks. We expect eurozone construction output to increase by about 2% a year in 2016-2017, supported by real GDP growth of about 1.3%-1.4% and continued accommodative monetary policy by the European Central Bank (ECB). Low interest rates and cheaper mortgages improve home affordability and attract first-time buyers to the market. An inflow of refugees has also bolstered housing demand in some countries (e.g. Sweden).

2. **Pricing conditions remain tight**
   
   Although we expect to see construction activity increase, pricing conditions for heavy materials producers remain tough due to overcapacity, mainly in emerging markets. This overcapacity is especially relevant for cement, ready-mix, and aggregates producers, and often stems from excessive investment by companies over the past several years. We have also observed overcapacity in some developed markets, such as Italy, where construction activity and cement consumption has yet to pick up. That said, we expect continued consolidation in the industry and optimization efforts by larger firms to help reduce overcapacity over the next two years, which could lower price competition.

3. **Rising fuel and energy input prices could constrain margins**
   
   We believe that energy costs have bottomed out in 2016. Given the recent increases in oil and coal prices, we are already assuming an increase of energy costs in 2017, which could be 7%-9% in some regions. Given that the current market conditions—specifically, very low consumer inflation in developed countries and significant production overcapacity in several developing markets—limit companies’ ability to increase prices, this will likely affect companies’ margins unless they implement actions to significantly increase energy efficiency.

**Latin America**

1. **Mild top-line growth**
   
   Revenue growth measured in U.S. dollars would continue to be affected by soft volume sales and the strong dollar. In terms of volume sales, we expect some recovery in 2017; however, low commodity prices will continue to create budgetary constraints for governments and limit their ability to allocate incremental public resources for infrastructure development. Also, high inflation, increasing unemployment rates, and lower credit availability would pressure household income, leading to a decline in demand for housing. However, we see the geographical diversification (outside Latin America) of some of the major companies benefitting top line growth. The leading market position of some companies could also help to bolster sales in 2017, since they enjoy a strong bargain power with price accretion.

2. **Profitability will hold**
   
   Latin American cement producers have been posting higher margins than those of global peers, mainly as a result of competitive cost structures and pricing power. We expect EBITDA margins to trend toward the 20% area in 2017, which would be supported by ongoing cost-control initiatives amid lower demand, such as shuttering of less efficient plants and logistics structure optimization, as well as the ability to overcome inflation costs by passing them through to end consumers.

3. **Leveraged capital structures despite debt repayments**
   
   We expect companies to continue reducing debt in 2017. Debt reduction will be supported by strategies to contain investments and raise cash through the sale of noncore assets to preserve liquidity. We expect the weighted average net debt to EBITDA to drop below 5x and weighted average funds from operations (FFO) to net debt to exceed 15% in 2017. We continue to see mismatches between dollar-denominated debt and local currency-denominated cash flow generation as a potential risk for smaller and weaker credit profile cement companies.
Asia-Pacific

1. Stable year amid mild demand recovery
   In line with our GDP growth forecast for Asia-Pacific countries, we believe moderate growth of infrastructure and property construction in the region will support modest demand recovery for building materials. We expect China’s cement demand to stay in the low single digits, predominantly backed by infrastructure growth. In Korea, Japan, and Taiwan, we expect flat prices and stable profit margins as a result of the mixed effects of a property market slowdown, raw material cost volatility, and positive contribution from high-margin products. We forecast flat conditions for Australia’s building materials industry as housing starts taper off following strong growth in past years and infrastructure spending dips, especially in the energy sector.

2. Prices are stabilizing
   In most of APAC, we see a stabilizing price trend due to a demand recovery. We expect overcapacity to constrain pricing improvement in some regions, like China. We didn’t see a large capacity retirement in the past few years; however, self-disciplined production control between regional players helped to maintain prices.

3. Deleveraging overweight cash flow improvement
   Due to overcapacity, building material players in Asia-Pacific have trimmed investment and optimized cost structure. We expect leverage ratios, such as debt to EBITDA and FFO to debt, to moderately improve in 2017 (see charts 9 and 10). Our base-case assumes debt reduction will exceed cash flow improvement for building materials and forest products. In addition, we expect capital expenditure to decrease, lowering leverage.

North America

1. Accelerated interest rate increases
   Should a hawkish Federal Reserve raise interest rates too far or too fast, companies could find themselves less able to facilitate investment opportunities as their cost of capital rises. This could also threaten to lower the pace of acquisitions in the space, notable among private equity-owned companies, where high levels of debt are often employed. Finally, a steep rise in rates could derail end market growth by pricing out potential homebuyers and reducing home improvement spending.

2. Changes or uncertainty in the tax code, trade agreements
   The loss of the tax-deductibility of debt interest would almost certainly raise financing costs for companies across all industries, including building materials (but possibly more than offset by a general reduction in the corporate tax rate). Private-equity-owned companies could be acutely affected, because the loss of interest deductibility could raise borrowing costs and required return on investment hurdles, particularly in a rising rate environment. For companies that import components or products, heightened trade tensions with countries such as Mexico and China could raise costs and reduce margins. Even if not a direct importer, the impact of higher costs on the consumer of imported products could reduce income available for home improvements and other discretionary spending.

3. Too high acquisition multiples
   As the recovery cycle catches steam and sellers of companies demand higher multiples, acquirers will be forced to search for other avenues to invest their cash. For investment grade issuers, share repurchases, dividends, or debt repayment would be likely candidates, in addition to internal investments. However, the potential slowing of merger and acquisition activity overall could thwart further consolidation in the space and reduce future potential synergies and cost efficiencies.
## EMEA

### Overcapacity and emerging market exposure
Several of the large Europe-based multinationals at the top end of the companies we rate, specifically large cement producers, have a significant presence in emerging markets where we have identified a production overcapacity and price pressure. Should an economic slowdown in these markets slow the pace of construction activity, prices would come under significant pressure. Further devaluation of emerging market currencies against the U.S. dollar or euro could also depress numbers, increasing local or regional geopolitical risk.

### Political risks and Brexit
Europe is grappling with a patchy economic recovery and Brexit. The U.K.'s lengthy and complicated exit from the EU could erode consumer confidence in the U.K. and continental Europe, holding down the pace of construction. That said, the effect on the building materials sector would be delayed, especially for electrical equipment that is used later in the building process.

### Relaxed financial discipline
Relaxed financial discipline on the back of higher shareholder pressure for remuneration has become a key risk for 2017. In our view, more generous shareholder distribution may slow down companies' deleveraging plans following an acquisition. For example, in November 2016, LafargeHolcim announced that it will pursue a more generous dividend distribution and a share buy-back program beginning in 2017; in our opinion, this may mean the company will reduce leverage more slowly if operating performance deteriorates suddenly in its key regions.

## Latin America

### Overcapacity
Relatively low utilization rates among most Latin American cement makers could weigh on operating efficiency. We estimate that utilization rates in Brazil will remain at about 60% in 2017, well below the 75% before the country's economic downturn. Mexico is the second-largest market in the region, with about 40 million tons in cement sales and 61 million tons of installed capacity, while Peru's cement market has an installed capacity of 14 million tons and volume sales of about 10 million tons. Colombia is probably one of the countries with highest utilization rates, exceeding 75%.

### Delays in investments
High market volatility over the past 12 months has increased uncertainty on economic growth prospects for the region. Investment plans in some countries could be placed on hold and in some cases investors would move forward only after such market volatility dissipates. Low near-term investments would curtail the development of residential, industrial, and commercial projects, and undermine volume growth.

### Soft economic conditions
In 2017, we estimate annual GDP growth in the region of about 1.7%, and we consider that a 100 basis point (bps) decline in economic activity would result in at least a similar impact of 100 bps on volume growth expectations. In Brazil, for instance, we expect another difficult year in the cement industry, and we estimate negative volume growth in 2017. Also, despite the gradual decline in interest rates in that country, which remain at double digits, other factors such as inflation and unemployment continue to drag household leverage and disposable income, constraining demand prospects and limiting companies' ability to pass on inflation to clients. In Mexico, a cooling economy reflects heightened risks from changes in trade dynamics with the U.S., as well as still-low oil prices that reduce government nontax revenues and weak consumer confidence. All this translates into a GDP growth forecast of only 1.8% in this country.
Asia-Pacific

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<td>Overcapacity</td>
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<td>In our view, continued overcapacity remains a short-term risk for the building materials sector, particularly in China. We do not expect new capacity expansion for most companies, but industry consolidation could dampen profitability and amplify liquidity risks for small-to-midsize players.</td>
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<td>Currency risk</td>
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<td>Foreign currency risk is another risk in 2017. Appreciation of the U.S. dollar will burden borrowers with U.S. dollar-denominated debt and constrain raw material importers.</td>
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<td>Volatile raw material costs</td>
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<td>Commodity price volatility could apply pressure to building material players’ profitability. For instance, the coal price hike in the second half of 2016 largely eroded clinker and cement producers’ profit margins. In our view, cement producers with an effective cost structure or those that can continue to reduce production costs may be able to offset or reduce the impact of raw material cost increases.</td>
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Industry developments

**North America: further consolidation and more acquisitions funded by improved cash flow.**

The North American building materials space still seems to have room for more consolidation, particularly in small regional manufacturers and distributors, aggregates (as has been the case for several years now), and windows.

On the investment-grade front, large companies will continue to search for acquisition targets to expand their product portfolios as well as their geographic diversity. With leverage already reduced to the lowest levels in years and cash balances building up, they are only left with a few options to invest cash (internal investment, acquisitions, or returning money to shareholders). As acquisition targets demand higher multiples, there is the potential for greater share repurchase and dividend activity if companies cannot find reasonably priced acquisition candidates. For the speculative grade issuers, most of which are owned by financial sponsors, we expect the already rapid rate of acquisitions and consolidation of smaller companies to continue. However, if interest rates rise more than expected, acquisition activity could be slowed due to higher debt costs.

**EMEA: industry consolidation continues, particularly the cement sector**

The European cement market has consolidated further since the heavyweight merger of Holcim and Lafarge in 2015. In October 2016, HeidelbergCement completed the acquisition of Italcementi, creating the second-largest global player. Both consolidated groups divested assets to comply with competition authority requests or to protect the combined group's credit metrics. These assets, in turn, have strengthened the market positions of the players that acquired them. For example, Ireland-based CRH acquired most of the assets that LafargeHolcim disposed of, and Italy-based Cementir has acquired Italcementi’s assets in Belgium.

Some small cement producers are merging or absorbing assets from distressed companies, especially in more-fragmented markets such as Italy. Similar consolidation is taking place in other niche and specialty areas. Some of our rated issuers have previously demonstrated their appetite for midsize acquisitions of up to €100 million, if the right opportunities present themselves. Some issuers are following emerging markets such as Brazil, because opportunities may arise to acquire recently built, technologically advanced plants at much lower than usual multiples because weak local market conditions have distressed their owners.

In our view, consolidation could increase pricing discipline and trigger a modest reduction in the supply-and-demand imbalance in some cement markets. We anticipate that future acquisitions are likely to involve asset divestments or asset swaps aimed at achieving streamlined and optimized
country positions, satisfying competition authorities’ requirements, supporting processes to reduce debt, or financing more-generous shareholder remuneration. For example, in July 2016, LafargeHolcim announced a further Swiss franc (CHF) 1.5 billion asset disposal plan to be completed in 2017, on top of the CHF3.5 billion in divestments it implemented in 2016, and large part of the proceeds will finance more-generous shareholder remuneration.

**Latin America: uneven risks in the region during 2017**

Size and scale are key for the cement producers and have spurred consolidation over time among Latin American players. A high operating efficiency by minimizing production and other operating costs and embedding flexibility in the cost base (i.e., a higher percentage of variable costs) may bolster profitability and cash flow over the business cycle. In each of these countries, the largest cement producers’ dominant market position historically increased their efficiency, boosting cash flow generation. However, we expect low utilization rates among most Latin American cement makers as the likely soft demand weighs on their operating efficiency. Higher inflation and unemployment rates could hamper the companies’ ability to pass on cost increases to customers. Nevertheless, in our view, Mexico’s cement producers, compared with their regional peers, benefit from the more balanced supply-demand dynamics.

In general, we consider that a 100-basis-point (bps) decline in Latin America’s GDP would result in at least a similar impact on cement volume growth because the industry is vulnerable to country risks. For example, low commodity prices have reduced governments’ nontax revenues. As a result, lower government infrastructure spending could hurt the financial performance of domestic cement producers amid 2017 budget cuts for investments. Lower government revenues add to the risk of public budget execution over the next political cycles in countries like Brazil, Mexico, and Colombia.

Overall, we believe the main risks for the region are a further drop in economic growth prospects, potentially lower government spending, and high interest rates. The latter, along with increasing unemployment, hinder mortgage and refinance activity and take a toll on household leverage.

**Asia Pacific: building materials sector to remain stable amid mild demand recovery**

We see an improvement and stabilizing trend in 2017 despite the negative bias, which reflects the effects of some companies’ weakened debt and interest serving capacity in 2015. In our view, downstream demand for building materials in Asia-Pacific will pick up over next 12 months, thanks to infrastructure projects and property market growth, particularly in China. We anticipate that key risks include foreign exchange losses, higher raw material costs, and some companies’ aggressive investment appetite.

More specifically, for China’s building materials sector, we expect production volume to remain subdued in 2017. Infrastructure recovery and property industry growth will fuel demand growth. We believe the increase in approvals on infrastructure projects led by the government and the government’s “One Belt, One Road” (OBOR) initiative will underpin a pick-up in new starts in the coming quarters. Supply curtailment remains a long-term benefit for supply-demand equilibrium and price recovery. However, small players may stay under financial pressure and struggle in the industry consolidation. Large companies, on the other hand, are leveraging economic scale to cut costs and looking to form alliances on pricing to survive competition. We expect liquidity for most companies in Asia-Pacific to remain adequate. Companies with aggressive capital spending or heavy reliance on short-term financing may face near-term liquidity risk.
Financial policy

North America: As discussed, investment grade issuers have low leverage on a relative basis, so seeking outside investment opportunities would seem to be priority one, with share repurchases and dividends being secondary strategies. What may become key in the discussion are initiatives by the new Trump administration. The impact of tax on imports/tariffs and any retaliatory measures taken by trading partners is one area to focus on, because this could add significant costs. While a cut in corporate tax rates would add more to the bottom line, the possible loss of the interest deduction would have an opposite, but in our view, not totally offsetting effect. A tax holiday on the repatriation of foreign cash is another item on the table, because companies with cash overseas would likely bring it back to the U.S. for investment.

EMEA: We expect a general deleveraging trend across the building materials sector because of some market recovery in Europe, price stabilization in some emerging markets, and strict control on capital spending. We continue to monitor companies’ financial discipline, on the back of higher shareholder pressure for remuneration, which may put pressure to ratings.

Latin America: Financial policy will continue to focus on deleveraging and protecting liquidity. We do not expect high M&A activity; the execution of major share repurchase programs; nor the expansion of capital investments, which would allow companies to use cash flow generation (both from operations and asset sales) for debt repayment. We would also expect companies to build on cash reserves to preserve liquidity, and, when market conditions permit, we anticipate liability management to mitigate potential refinancing risks.

APAC: We expect a general deleveraging trend across the building materials and forest products sectors because subdued market conditions across Asia will keep a lid on expansion plans for most companies. For some players in the sector with aggressive acquisition appetite, capital management remains under control but rating headroom has reduced. Disciplined financial policies and capital spending curtailment support our base case and stable outlook for the building materials sector.

Under Standard & Poor’s policies, only a Rating Committee can determine a Credit Rating Action (including a Credit Rating change, affirmation or withdrawal, Rating Outlook change, or CreditWatch action). This commentary and its subject matter have not been the subject of Rating Committee action and should not be interpreted as a change to, or affirmation of, a Credit Rating or Rating Outlook.
Cash, debt and returns

Global Building Materials

Chart 11 – Cash and equivalents / Total assets

Chart 12 – Total debt / Total assets

Chart 13 – Fixed versus variable rate exposure

Chart 14 – Long term debt term structure

Chart 15 – Cash flow and primary uses

Chart 16 – Return on capital employed

Source: S&P Global Market Intelligence, S&P Global Ratings calculations