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HeidelbergCement AG

Investment Recommendation

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I would buy **HeidelbergCement AG** common stock (ticker symbol **HEI:GR** on the Deutsche Börse Xetra) at a price of €60 or less per share because I understand the company; it's good; and at €60 per share, it's inexpensive. Its FCF generation will rise significantly in the next couple of years because interest payment will come down from €450m in 2016 to approx. €200m in 2018 when old high yield bond expires and get refinanced at 1.5-2.0%. Calculating with management's 2017 MCAPEX guidance of €700m and ND target €8.5 billion the stock is already close to fair value. The stock currently trades at € 81(-8% YTD) with a market cap of €16 billion, it has a history of above market volatility and it has a high exposure to US government infrastructure spending programs which could depress the stock price during a prolonged federal government shutdown.

Products: HEI is the 2nd largest global cement manufacturer with high deposits of the key raw material limestone (cement capacity 192 million metric tons with 143 owned plants and 17 plants in JVs). The integrated production processes include the extraction of raw materials, the energy intensive production process of building materials and their marketing and distribution to the customers. The main products are **cement and clinker** (2016 revenue € 8.8 billion) and **aggregates** (€ 3.5 billion). In addition, some of its cement is processed further and sold as **ready-mixed concrete** and **asphalt** (€ 4.9 billion). Those building products are standardised bulk goods whose price is determined by local supply and demand. At an average 2016 sales price of € 70 per tonne for cement and €12 per tonne for aggregates it is typically sold within a 200km range of the production side and excess supply with easy access to sea harbours is shipped to nearby regions.

Customers: Concrete is widely used in construction by both public-sector clients (50% of HEI's cement demand and 50-60% of its aggregates demand), private construction companies (20% and 20-25%, respectively) and private residential homebuilders (30% and 20-25%).

Industry: The global cement industry has approx. 4,200 million metric tons annual production capacity (China 1450, India 300, USA 114) and outside China and India it is consolidating at a fast pace. The 2015 merger of the global leaders **Lafarge** (Capacity 225 (Mt/yr) and **Holcim** (217 (Mt/yr), and **HEI's** 2016 take-over of **Italcementi** (74 (Mt/yr) should help to make global production more energy efficient and less reliant on burning coal, which requires CO_2 emission certificates. The emission rights will continue to be allocated free of charge, but by 2020 their quantity will have been reduced by 21% compared with 2005. HeidelbergCement spends 0.7% of sales on R&D partly to improving kiln efficiency and the use of biomass and other alternative fuels, among other technologies like CO_2 storage facilities. Furthermore, oligopolistic market structures and the exit of small local players should raise price discipline. Based on fresh memory of the market turbulence since 2007 all major producers now cherish "BBB"-investment grade ratings to keep low interest rates on their debt instruments. Like **HEI**, which acquired UK building materials group **Hanson Plc** for 8 billion pounds ($15.8 billion) to create the world's second-largest company in construction material in 2007 shortly before global demand collapsed, **Cemex's** (96 Mt/yr) US$ 14.2 billion acquisition of Australia based **Rinker group** in 2007 landed both company in a financial distress. Nevertheless, banks, bondholders and other lenders concluded at the time that stable FCF generation and a clear focus on debt reduction were best achieved by a going concern of those global players. The industry is characterised by strong working capital build-ups during the year as it is more efficient to purchase coal and raw materials well in advance.

Form: HEI is a German Aktiengesellschaft (AG) which a holding structure. Cash is allocated in the group via intercompany loans from HeidelbergCement Finance Luxembourg S.A. Nevertheless. A high portion of group's cash sits in local subsidiaries. The company wholly owns most subsidiaries other than in countries where local JV partners are necessary, like China, India or Indonesia. Since 2005 HEI is controlled by Ludwig Merckle who owns 25.5% of the shares and who previously applied financial leverage to control most of the group, which added to the uncertainty during the 2008-09 financial crisis. In the following years the company avoided formal restructuring but was put on leash by the creditors with strong bond covenants, high coupons on new bonds and a focus on deleveraging.

Geography: HEI has a global present in 60 countries except in highly profitable South America. The recent acquisition of Italcementi complements HEI presents in West- and Southern Europe and in Asia. The production facilities in Africa and Indonesia are close to the sea and enable cheap seaborne transport. Revenue split: North America 2016: €4.0 billion, Northern and Eastern Europe-Central Asia €2.4B, Western and Southern Europe €3.9B million , Asia-Pacific €2.9B and Africa-Eastern Mediterranean Basin €1.3B and Group Services €1.1B. The headquarters are in D-69120 Heidelberg, Germany

Status: HEI is a global market leader in building materials and leading in environmental standards

Performance Metrics (FY 2016 HEI incl. Italcement)

ROCE with cash, end of period	13%	(Goodwill is subtracted)
FCFROCE with cash, end of period	4%	(8% with lower interest payment & MCAPEX)
Δ OI/FDS	13%	
Δ FCF/FDS	53%	
Δ BV/FDS	12%	
Δ TBV/FDS	0%	
L/E	108%	

Breadth analysis

- No customer accounts for 10% or more of sales
- The Company purchases raw materials and energy (coal), none of which is material to HEI business

Force analysis

❶	Bargaining power of customers	(low)	Customers can only source locally
❷	Bargaining power of suppliers	(low)	But sometimes is important to secure access through M&A
❸	Threat of substitutes	(low)	All substitues are more labour intensive
❹	Threat of new entrants	(high)	Local players often seek volume growth irrespective of P&L

Moat identification

❶ Government (low)
❷ Cost (low)
❸ Brand (low) homogeneous bulk product
❹ Network (low)
❺ Switching costs (low)
❻ Ingrainedness (low)

Market growth assessment long term about GDP growth (currently US/UK slow, but strong growth in some regions (e.g. Norway, Sweden)

Shareholder Friendliness

❶	Compensation and ownership	(fine)
❷	Related party transactions	(Not material)
❸	Share Repurchase	(there are none - Shareholder friendly)
❹	Dividends	(approx.. 40% of Net Income = Shareholder friendly)

Price per share	€ 81	
Shares outstanding	193,023,000	
Market cap	15,634,863,000	
Enterprise value	32,943,663,000	
Free cash flow	861,800,000	
Operating income	2,939,400,000	
Book value	17,872,600,000	
Tangible book value	5,552,900,000	
MCAP/FCF	18	(ideal < 8)
EV/OI	11	(ideal < 7)
MCAP/BV	0.9	(ideal < 3)
MCAP/TBV	2.8	(ideal < 3)

Investment Recommendation Scenario

Price per share	60	
FCF (expected)	€ 1,411,800,000 (+250m interest relief and -300m MCAPEX)	
MCAP/FCF	8.2	(ideal < 8)
EV/OI	9.8	(ideal < 7)
MCAP/BV	0.6	(ideal < 3)
MCAP/TBV	2.1	(ideal < 3)

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