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Leaner and greener

Evan Lorenz writes:

Last week's blue wave was less than ankle-deep, but a green tsunami is sweeping through the asset-management industry. According to Morningstar, Inc., funds that hew to ESG-related mandates (including the funds that only just found green religion) soared past the $1 trillion mark this summer.

Which is "great for the industry because it's active money that comes with higher fees," Edward Glyn, head of global markets at Calastone, told the *Financial Times* in August. "Plus, it's something that investors want." In preview, we're skeptical about the positive impact of ESG funds but bullish on HeidelbergCement A.G. (HEI in Germany), a cheap company in a dirty industry.

For a thoughtful and unconventional view of the green investment wave, allow us to suggest the Nov. 2 edition of the *Grant's* Current Yield Podcast, entitled "ESG 101." In it, Will Thomson, founder and managing partner of Massif Capital LLC, describes what an effective ESG-themed investment is and isn't. The written version of the argument—"Failure to Impact: Are ESG Funds Delivering on Investors' Ambitions?"—has been posted on Massif's website.

Too often, the Massif authors contend, greenish asset managers assemble a portfolio of companies that pass environmental muster because they've already achieved best practice. They can't drive further environmental change (except by example), because they've already changed: "Investors can thus rightly ask, 'If my ESG ETF investment produces no positive impact, does it, by dint of directing capital away from firms critical to transitioning the economy to a more sustainable footprint, do more harm than good?'"

Make up your own mind by peering under the hood of a typical ESG exchange-traded fund. The Vanguard ESG U.S. Stock ETF, for example, counts Apple, Inc., Microsoft Corp., Amazon.com, Inc., Alphabet, Inc. and Facebook, Inc. as its top five holdings. These are also the five largest constituents of the tech-heavy Nasdaq 100 and the S&P 500.

"That firms such as Apple and Microsoft . . . pollute less than copper miners and aluminum producers is a meaningless observation in the context of a desire to invest for impact," the Massif authors argue. "That firms like Apple and Microsoft depend on copper miners and aluminum producers for their businesses means that the question investors should be asking is how one balances environmental impact and economic criticality, not simply how one limits a portfolio's overall environmental impact."

Yes, Apple has pledged to reduce its emissions, but there aren't many to reduce. Cupertino's "carbon footprint (scope 1, 2 and 3 emissions) in 2018 was just 25.1 million metric tons of CO_2, or 0.5% of all U.S. energy-related CO_2 emissions in 2018," say the authors. "To suggest that Apple has no meaningful impact on climate change in the present, and no significant effect on the future, is not far off the mark."

How to measure ESG compliance is another problem. Credit ratings issued by the likes of Fitch Ratings, Moody's Investors Services and S&P Global Ratings are 99% correlated, a 2019 MIT Sloan School of Management paper found. If that result suggests conformity, it likewise points to the existence of objective facts to weigh.

Consider, next, five ESG raters. Their verdicts, the MIT researchers found, showed a correlation of just 61%. If this suggests independence of judgment, it also admits the possibility of a paucity of objective evidence.

Air Products, Inc. is a company that typically ranks high on the ESG charts. It's also a company that, upon completion of a series of planned coal-gasification plants in Asia slated for 2026, would become one of the five biggest CO_2 emitters in the S&P 500, according to Massif's reckoning.

Cement-making is an unclean business. It accounts for 8% of global greenhouse-gas emissions, and you half-expect the earth to be warmed by the process of creating a batch of the stuff. Thus, to make clinker, the main cement input, you heat limestone to 2,640 degrees Fahrenheit. Carbon is released in the burning of coal, gas or another fuel to reach that temperature—and then again in the chemical change that limestone undergoes in the searing heat.

But cement is as essential as it is dirty, and making it greener is one of the keys to controlling greenhouse-gas emissions. Between 1990 and 2019, Heidelberg reduced the amount of carbon emitted per metric ton of concrete to 590 kilograms from 749 kg, a 21% decline. On Sept. 16, management pledged to slash such emissions to 525 kg in 2025 and 500 kg by 2030, with the ultimate goal of carbon neutrality (at least in concrete) by 2050.

"We have found that when people set out these goals that are short-term, medium-term and long-term, rather than just saying, 'By 2050, we will be net neutral,' those companies seem much more capable of achieving their goals," Thomson tells me.

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Heidelberg was founded in the southwest German city of the same name in 1874. Following a string of acquisitions at the start of the 20th century, the cement giant achieved 1 million metric tons of production in a single year. That was in 1936. Today, the capacity exists to make almost 200 million metric tons of that signature product every year.

Cement is supplemented by aggregates (sand, gravel and crushed stone), ready-mix concrete (a blend of cement and aggregates) and asphalt (a mix of bituminous pitch and aggregates). Heidelberg is the world's largest producer of aggregates, the No. 2 player globally in cement and the third largest maker of ready-mix. It's active in over 50 countries, which it services from over 3,000 production sites and with more than 50,000 employees.

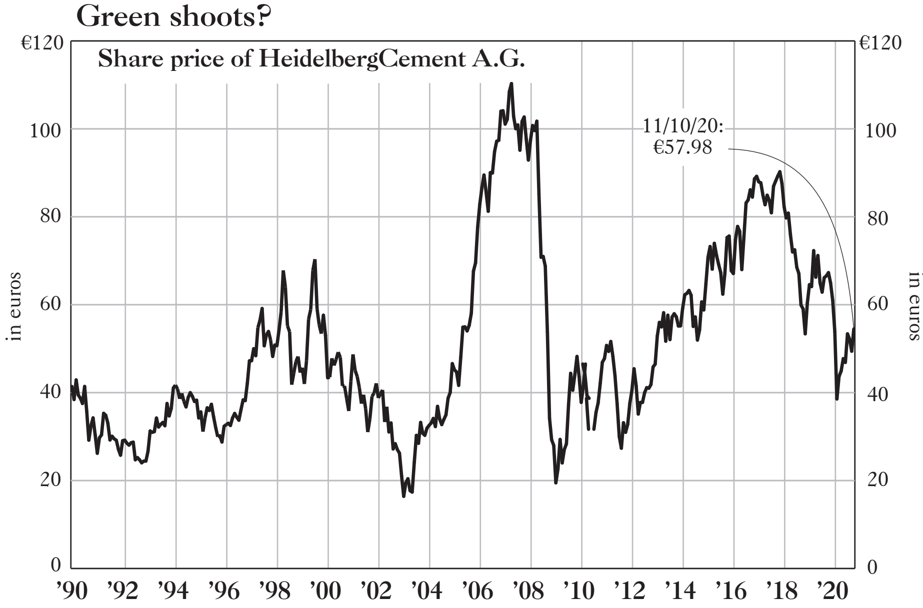
In the third quarter, sales on a like-for-like basis dipped by 1% to €4.9 billion ($5.8 billion). Europe dominates the mix at 45.2% of September-quarter revenues, followed by North America (28.7%), Asia Pacific (16.5%) and Africa and the Mediterranean Basin (9.5%). The plunge in sales notwithstanding, lower energy prices and a cost-cutting program forehandedly begun in February, before the pandemic, led to a 16.5% comparable rise in Ebitda.

"The industry is obviously not in favor—not 'woke,' so to speak, if I may call it that—given that they contribute 8% to CO_2 emissions worldwide, and that is a serious issue," a European analyst tells me (he asks to go nameless).

The bear case continues with the proposition that past performance is, in the case of Heidelberg, sadly indicative of future results. The sorry 2.4% compound annual rate of return that the shares generated over the past three decades (denominated in euros and including dividends), compares to 6.7% for the blue-chip DAX index, of which Heidelberg is a constituent company. The results are testament to a reverse Midas touch in capital allocation.

Management must have had few corporate peers in the undesired art of buying high and selling low. Thus, on Aug. 30, 2007, Heidelberg completed the acquisition of Hanson Ltd. for £9.2 billion ($18.7 billion at the time), or 11.1 times trailing Ebitda. For reference, Heidelberg today trades at 6.1 times estimated 2020 Ebitda and commands a $13.6 billion market cap.

Green shoots?



source: The Bloomberg

You won't have forgotten the American mortgage-cum-housing-cum-overall-debt bubble of that era, with variants blighting Spain and the United Kingdom. Management almost caught the top of that toxic cycle. According to the data company Statista, cement consumption in the United States decreased by 20% from its housing-boom peak through 2019.

Hobbled by leverage, which rose to over five times Ebitda in 2009, Heidelberg sold 62.5 million shares, or 32% of total shares outstanding today, to right-size its balance sheet. That, too, was in 2009. The deal was disastrous for the Merckle family, prominent German entrepreneurs who owned 80% of the company in 2007. Pressed by debts secured by its Heidelberg share holdings as well as other investment losses, the family sold down its stake. Today, it owns 25.5% of the common.

Nor was Hanson Cement the only overpriced acquisition. In 2016, Heidelberg paid €4.2 billion to acquire Italcementi S.p.A., Italy's leading cement manufacturer, for a 10.4 multiple of Ebitda. As a result of these and other deals, Heidelberg's balance sheet shows €9.4 billion in goodwill and intangibles, even after a €3.5 billion writedown in the first half of 2020.

There's concern, too, that China could flood the world with supply. Its domestic titans, such as Anhui Conch Cement Co., Ltd., have used cheap capital to build kilns outside of the People's Republic, pressuring incumbents like Heidelberg in the process. Or, so the bearish story runs, China's redundant home cement-making capacity might be harnessed in the service of a margin-killing export drive.

Of the 28 analysts who follow the stock, 15 say buy and none says sell. Over the past 12 months, insiders—excluding the Merckle family—have bought 21,994 shares at a net price of €1.2 million, or €56.51 per share versus the current price of €57.98. No insider has sold a share in the past year.

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The bears' concerns are more than reflected in the share price, however, quoted at 9.8 times 2019 earnings and 8.5 times the 2021 estimate. (The previously mentioned writedowns have clubbed this year's earnings.) Based on consensus expectations, Heidelberg trades at six times 2021 Ebitda, a discount to the average 8.6 multiple at which the shares changed hands over the past decade.

On Feb. 1, Dominik von Achten, age 54, a former employee of the Boston Consulting Group who joined Heidelberg in 2007 to run, among other units, the North American division, was appointed chairman of the managing board (equivalent to CEO in a U.S. company). The new boss is setting a new corporate course. Large, transformative acquisitions are off the table, he told listeners-in at the Sept. 16 capital-markets day; the front office will focus instead on disposing of non-core assets or underperforming plants. While von Achten did not specify which parts of the company might go on the auction block, he indicated that as much as 30% of the asset base is vendable.

In addition to the aforementioned environmental goals, von Achten set a list of 2025 financial objectives. Among them: an 8% return on invested capital, compared to the 6.5% earned last year (a stunted result directly attributable to those overpriced acquisitions). In addition, commendably, management dropped a bespoke ROIC calculation in favor of the conventional, less flattering (by 0.4 percentage points) metric. Beyond divesting low-return operations, Heidelberg aims to boost Ebitda margins by 3 percentage points, to 22% from 19% in 2019, by reinvesting in plants, trimming costs, digitizing customer orders and automating internal workflows.

Less debt is likewise on the agenda, with management aiming for a leverage ratio (inclusive of capitalized leases) of between 1.5 and 2.0 times, from 2.4 times at year-end 2019 and 2.1 times as of Sept. 30. Rated Baa3/triple-B-minus, Heidelberg generated operating income that covered interest expense by 5.7 times in the first half of this year.

"Going forward, we will prioritize the improvement in margins and ROIC over growing the top line," von Achten told analysts. "We shift our portfolio focus to the optimization of core assets, while we stay committed to our balanced global footprint. We will ensure strict capital discipline. Capex spending will be done with a focus on asset-based improvement and financial returns. Very importantly, larger bolt-on M&A needs to be funded through portfolio disposals. We will accelerate our innovation in CO_2 and digital as the frontrunner in the building-materials industry. And, last but not least, by doing so, we offer attractive returns to you, our shareholders, by giving you a progressive dividend and also leave open the option for share buybacks."

Of course, many management teams say the right thing and do something different. In von Achten's favor, Heidelberg began Project Cope in February to trim unnecessary spending and boost liquidity at the start of the pandemic. Management has earmarked the year-to-date savings, €721 million, for debt reduction; on Sept. 30, net debt (again, inclusive of operating leases) summed to €7.9 billion, down from €9.7 billion a year ago.

"I think the most significant development is that we have generated €2.3 billion of free cash flow over the last 12 months," CFO Lorenz Nager enthused on the Nov. 5 earnings call. "This is a historic high figure, and it is up €0.8 billion from the previous 12-months period."

Heidelberg at a glance

all figures in € millions except per share data

	TTM	2019	2018	2017	2016
sales	€17,894	€18,851	€18,075	€17,266	€15,166
Ebitda	3,545	3,580	3,100	3,297	2,887
net income	-2,255	1,091	1,143	918	657
net debt	8,994	8,410	8,323	8,695	8,999
equity	14,637	18,504	16,822	15,987	17,792
total assets	33,619	38,589	35,783	34,558	37,120
cash flow from operations	2,788	2,664	1,968	2,038	1,874
cash flow from investing	-965	-906	-1,134	-837	-2,321

* 12 months ended June 30, 2020.

source: company reports

The threat of Chinese competition is real, but there's a reason that cement is rarely shipped more than 200 kilometers (124 miles) from its place of manufacture; the ratio of value to bulk in each 43 kg (94 lb) cement bag discourages exports, and the value of Chinese cement and clinker exports have long been in decline: to $129.8 million in the first nine months of the year, from $347.3 million in the 12 months of 2019 and from $796.6 million in 2013.

By the nature of its business, Heidelberg is a beneficiary of government stimulus spending. While the Democrats may have failed to capture the Senate (we'll know more in January), current majority leader Mitch McConnell said last week that he aims to pass a spending measure before year-end. Bloomberg has reported that the European Union is nearing completion on its own €1.8 trillion stimulus package.

"[S]timulus money just doesn't go [out] overnight," von Achten said on the Nov. 5 earnings call. "But this is something that we're expecting to kick in more in 2021 and onwards."

Heidelberg is cheap, slowly turning green and has a balance sheet on the mend. To date, investors are withholding credit for management's margin targets, but success may just prod Mr. Market to sit up and take notice.

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