CemExec: Terry Pavlopoulos, Construction Knowledge

A short while ago, CemWeek featured an in-depth article titled "The current economic climate and the opportunities for cash rich cement players" by Mr. Terry Pavlopoulos, Managing Director of Construction Knowledge. The article raised a number of interesting issues regarding the future development of the global cement sector.

CemWeek now follows up with a discussion with Terry on recent changes and outlook facing the cement sector and the opportunities he sees for deal making going forward.

CemWeek: Can you elaborate on the changes that the sector has been through which resulted in this "perfect storm"?

Terry Pavlopoulos: Prior to the recent crisis the cement industry went through an unparalleled period of growth. Most markets experienced above "long term trend" growth rates. The financial performance of the industry was excellent and as a result it attracted numerous new entrants. We also saw substantial capital investment either in the form of capacity additions or acquisitions. So, just before the crisis the industry found itself with:

- Substantial new capacity commitments
- Increased indebtedness
- Substantial new capacity in the hands of newcomers

When the crisis appeared the above characteristics worked against the industry. The new capacity additions are expected to create supply-demand imbalances which will result in lowered prices, the high level of indebtedness leads to financial distress which at best impedes growth and the numerous new entrants increased the fragmentation of many regional and national markets. We also believe that this "perfect storm" has established a new set of strategic drivers that will govern the sector in the post crisis era.

CW: Can you elaborate on the new strategic drivers that face the cement industry in the post crisis era?

TP: This is best done by comparing the drivers in the pre crisis era with the drivers now. In the pre crisis the drivers were:

- Address tight supply demand balance by introducing new capacity
- Increase debt positions by heightened M&A and other CAPEX activities

In the post crisis era the strategic drivers are:

- Address deteriorating financial performance
- Improve specific market dynamics
- Effective cash management

It is our belief that the companies that understand and address these new drivers will be the winners in the post crisis period.

CW: The article mentions the reversal of the trend between majors and emerging markets players. Does this mean that the major cement players will disappear?

TP: The major cement players are on the whole very well managed and ambitious businesses that find themselves (some of them) in a difficult situation. We believe that the majors will not disappear but the future shaping of the sector may largely be out of their hands. What we mean is that given their relative inability to invest they may not be able to participate in the corporate activity that will shape the industry in the next 3 to 5 years. However, the majors' relative position in the global cement order will depend on whether other smaller but financially unencumbered players raise their game and capture industry shaping opportunities.

CW: We haven't yet seen many transactions in the sector post crisis. Can you offer an explanation as to why this is the case?

TP: Most cement companies are currently interested in only two initiatives: cash preservation and cost cutting. Cash preservation is driven by the industry's intense insecurity regarding the short to medium term development of cement markets. So, prospective buyers are reluctant to commit cash at the moment in case they need it later. In addition, the current perspectives on valuation between buyers and sellers are out of synch. What we mean is that the buyers, given their uncertainty, seek to acquire businesses at rock bottom prices thus minimising the impact of further macroeconomic deterioration. The sellers on the other hand hold on to memories of deals in 2005, 2006 and 2007 that were transacted at historically elevated multiples. This divergence is a serious obstacle to potential transactions. One or two very recent deals indicate that things may be improving. It must be noted that given the latest spate of rights issues and debt refinancing, the sellers may now chose to hold on to assets rather than sell them for what they consider a value destroying price.

CW: Do you not think that cash preservation is currently the right policy for cement players?

TP: We believe that cash preservation is the right, indeed the only policy for financially strained companies. For the ones that have cash the options are far wider than merely sitting on their hands waiting for the storm to blow over. It is evident that the emergence of strong cement players that can challenge the majors can only materialise if they commit substantial investment to emerging opportunities. It cannot be expected that any cement company will emerge through this crisis stronger if it fails to take difficult and at times risky decisions during this period of upheaval. However, as explained above, investing under the current circumstances is a tough decision and requires strong commitment to the sector by both the management and the owners.

CW: How do you see the sector developing in the next three to five years?

TP: We know that the global cement industry is going through unprecedented turmoil. This is what we may term a severe market discontinuity. It is a well-documented fact that such discontinuities create winners and losers.

We believe this to be the case in cement. In order to imagine the sector in the future one needs to examine its current main characteristics that are:

- Many companies are indebted and experience substantial demand reversals in their main and most lucrative markets
- The attendant financial distress must be relieved by effective cash management, support from the funders (both equity and debt) and disposal of peripheral assets
- There are still players that have the cash and ability to expand beyond their existing markets

As a result of the above, we expect increased fragmentation in the global cement industry (as measured by the percent of total capacity in the hands of the ten largest players). Even if smaller players do not avail themselves of acquisition opportunities, it appears that despite the crisis, industry outsiders show an unabated enthusiasm to join the sector and thus increase fragmentation. As part of influencing specific market dynamics we also anticipate substantial activity in vertical integration.

The dynamics of international trade may also change as securing downstream assets in destination markets will become an essential part of exporting. In terms of ownership, we expect many assets changing hands across various markets - it is estimated that up to 70 cement (or related) assets are being considered for disposal across the globe as part of “core business focus” of many players. Asset swaps may also become fashionable as some producers seek to align efficiently their vertically integrated production configuration.

We may see a few IPOs in certain markets. Even the hitherto reluctant private equity investors may show an interest as they begin to understand the cyclical but lucrative nature of the sector. This variety of outcomes coupled with the diverse nature of protagonists will make the cement industry a very exciting place to be in the next three to five years. I defy anyone to find a more interesting sector of the global economy.

CW: Finally, can you tell us a bit more about your company?

TP: Construction Knowledge is an advisor to the building materials and construction industries. Cement and its downstream products is the strongest area of our expertise. Our team consists of industry professionals with at least twenty years experience in the sector. We assist organisations involved in the sector with their strategic projects (projects which invariably lead to capital investment and/or major organisational change) and with delivering M&A transactions. We approach projects from an industrial point of view but we back that with excellent analytical and financial skills and capabilities. It is our belief that an industrial assessment of a business undertaken by Construction Knowledge provides in-depth insights for both operators and investors in the sector. Our network includes industry professionals ranging from the CEOs and CFOs of major organisations to local entrepreneurs and thus our insights of what is going on in the industry are unique. Construction Knowledge is a truly independent consultant determined to deliver the highest standards of integrity and professionalism in the sector.

For more information on this article, please contact Managing Director Terry Pavlopoulos at terry.pavlopoulos@constructionknowledge.biz, or +44 1844 273651.

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