PRUDENTIAL **INSIGHTS**

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Ielhaam Ismail
Equity Analyst

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Cement's Changing Landscape

ARTICLE SUMMARY

One of the industries most likely to benefit from Africa's growing economies and infrastructure expansion is the cement sector. We examine the market in sub-Saharan Africa.

Investing in Africa is becoming increasingly popular as investors gain a better understanding of the markets and companies active on the continent. Rising income levels, improving economic growth rates and evolving financial markets have contributed to a decline in risk, while also creating the conditions for attractive investment returns.

Prudential has been investing in Africa for six years now, offering institutional investors with specialist mandates the opportunity to benefit from the relatively high growth prevalent in certain countries in the region and additional international diversification. Currently we have nearly R4.0 billion in African equity assets under management. To give more clients improved access to our best African investment ideas, we have recently launched a new unit trust, the Prudential Africa Equity Fund. Four of our popular unit trusts, including the Prudential Equity Fund, the Prudential Dividend Maximser Fund and the Prudential Balanced and Inflation Plus Funds, are gaining their exposure to our prudently selected African stocks by investing in this fund.

This means that Prudential clients who are invested in these funds will have some exposure to Africa's growth potential, although in small weights as a percentage of each of the funds.

AFRICA'S EXPANDING INFRASTRUCTURE NEEDS CEMENT
One of the industries most likely to benefit from Africa's growing economies and infrastructure expansion is the cement sector, and it is one we have been analysing closely. Historically the African cement industry has been dominated by large multinationals – the likes of Lafarge, Holcim (these two companies merged in July of 2015, now LafargeHolcim) and Heidelberg were, and still are, key players in a number of sub-Saharan Africa (SSA) markets. Lafarge, in particular, has been present in Africa since 1985 and has operations in South Africa, Nigeria, Kenya, Zambia and Zimbabwe, among others.

In 2012 sub-Saharan African cement producers were generating EBITDA (earnings before tax, interest, depreciation and amortisation) margins of around 40%, and until this point markets were characterised by solid fundamentals including strong growth, good capacity utilisation rates and attractive pricing. However, the subsequent entry of new players and increased capacity by both the new entrants and incumbent producers have resulted in increasingly competitive markets in which pricing has come under significant pressure. And with lower prices per tonne of cement, lower margins have followed. Following are some market highlights:

NIGERIA
Dangote Cement started its manufacturing operations in Nigeria in 2007, at a time when local producers were unable to meet the demand. In 2006 local demand was almost four times that of local supply, with the deficit being sourced from imported cement. Dangote Cement currently has the capacity to produce almost 30 metric tonnes (mt) in Nigeria, versus 8mt in 2011. The market has moved from a capacity deficit to a surplus, basically eliminating the need for imported cement and helping reduce the cement price significantly: in 2012 a tonne of cement was being sold for US$170 (ex-factory gate), while today it sells for just below US$120. The Nigerian market now has a total productive capacity of 43.7mt, with

the two main players in the market being Dangote Cement and Lafarge Africa, a subsidiary of LafargeHolcim.

SOUTH AFRICA

In South Africa, Sephaku Cement (a 64%-owned subsidiary of Dangote Cement) entered the market in 2014 with 2.65mt of production capacity, followed by Mamba Cement in 2015, who added 1mt. With increased competition, prices fell as competitors battled it out for market share, and cement prices bottomed in May 2016. For PPC, one of the incumbent producers, EBITDA margins declined significantly from around 33% in 2013 (for the South African cement business) to 22% in 2017. Needless to say, earnings suffered.

ZAMBIA

Dangote Cement entered the Zambian cement market in 2015, increasing installed capacity in the country by 1.5mt and effectively exceeding the level of local demand at the time. In 2012 producers were selling cement at an ex-factory gate price of US$200 per tonne, but subsequent to the entry of new players, prices reached a low of US$80 per tonne. In their first year of operation, Dangote Cement achieved a 40%-45% market share.

To our knowledge, Dangote Cement targets around a 25-30% local market share in the countries in which they operate. It is now the 10th largest cement producer globally, up from number 27 in 2013, and is sub-Saharan Africa's largest cement producer with 45.6 metric tonnes of capacity across 12 plants and operating in 10 countries.

HEADWINDS FOR CEMENT PRODUCERS

Aside from competition, economic and political instability have further impacted the performance of the region's incumbent cement producers. In 2016/2017 cement demand in Nigeria fell by 17% on the back of a weak macroeconomic environment. A weak oil price, high interest rates and a significant devaluation in the naira versus the US dollar put the economy under severe strain. In the DRC, political instability has been driving violence and unrest for a number of years, in turn halving the total annual market demand for cement from 3mt in 2012 to only 1.5mt currently.

Slowing growth or softening demand, coupled with increased capacity, results in an unfavourable supply/demand dynamic and low capacity utilisation rates for cement operators. This, in turn, makes it more difficult for producers to cover the high levels of fixed costs inherent in the process of cement production: fewer tonnes of cement are manufactured and sold at a lower price, but the level of fixed costs remains unchanged, resulting in declining operating profit margins. Graph 1 clearly illustrates the drop in EBITDA margin for a number of the listed cement companies in SSA.

THE INVESTMENT CASE FOR SSA CEMENT

Across sub-Saharan Africa, cement companies' current capacity utilisation is low, with Nigeria operating at 51%, Kenya at 76% and South Africa at 72%. This is well below historic rates of utilisation. This excess capacity should act as a barrier to entry, dis-incentivising new entrants at a time when productive capacity exceeds demand, by keeping pricing low. Graph 2 shows the capacity utilisation levels across a number of sub-Saharan African countries, calculated as sales volumes as a percentage of the installed capacity in that country.

In some countries, we have potentially reached a turning point and companies could possibly now begin to focus their efforts on improving utilisation rates, cost control and consequently increasing profitability – as opposed to increasing capacity and fighting for market share. This would bring price stability back into the markets.

In the South African market, this appears to be the case: PPC has turned its focus to generating cost savings of R50 per tonne, which should support margins. In addition, the new entrants to the South African market are operating at full volumes, market shares appear to have stabilised and cement prices have started to increase. PPC has also expanded its reach to the DRC, Rwanda and Ethiopia in recent years. Their ambitious Africa expansion project has led to an increase in capacity of around 4mt over the last three years. We believe that these Africa projects are starting to contribute positively to the earnings of the group and by 2020 a large proportion of the group's earnings will come from outside of South Africa.

However, competition is intensifying in Kenya and Uganda. Bamburi Cement, a subsidiary of LafargeHolcim, is expected to commission additional capacity in both countries, and a number of competitors are also embarking on expansion plans. And so the battle for market share continues, as producers are enticed by the promise of growth. The Kenyan government continues to invest heavily in infrastructure; in recent years mega infrastructure projects like the Standard Gauge Railway have supported cement consumption. The government is currently embarking on phase 2 of this project, with a requirement that 60% of the cement be sourced from local producers.

Spending on infrastructure projects will continue to bolster cement consumption in Nigeria as well. The Nigerian government has committed to a substantial capital expenditure budget. The cement market in Nigeria has historically been driven by residential housing, so any potential uplift from government infrastructure spending is very positive for consumption trends.

From a global perspective, there is certainly the potential for higher cement demand in the region. Sub-Saharan Africa per capita cement consumption significantly lags the global average of 554kg per capita, with Ethiopia, Kenya, Nigeria and Tanzania all sitting below 150kg, and the DRC consuming as little as 35kg of cement per person. It's interesting to note that South Africa consumes 220kg per capita, above the SSA average of 100kg but still well below the global average.

In summary, long-term trends in SSA are positive: per capita cement consumption should trend upwards, supported by strong GDP growth and improving GDP per capita. Population growth, urbanisation and the growing middle class are all catalysts for greater cement demand. Demand for infrastructure, housing and commercial buildings will all drive the region's consumption. In fact, despite the headwinds mentioned above, cement consumption in SSA has grown by a compound annual growth rate of 7.2% between 2010 and 2017, well in excess of the global average of 2.7%. Based on the historic underinvestment in infrastructure in many African nations, we expect this trend to continue as governments attempt to close the infrastructure gap.

HOW PRUDENTIAL IS POSITIONED

Our South African and Africa funds are overweight a combination of PPC, Lafarge Africa and Bamburi Cement. These counters, we believe, are attractively valued, with a positive outlook for earnings and distribution growth in the long term, potentially adding good value to our clients' returns over time.

Our approach to investing in African equities, while rooted firmly in our long-standing valuation-based process, places extra emphasis on choosing high-quality companies whose earnings are resilient enough to withstand potential political and economic disruptions. We therefore take a longer-term view when deciding which shares to invest in, with the intention not to trade as frequently as in our South African unit trusts, given the higher costs involved. Importantly, we also urge clients to adopt this same long-term approach in order to benefit the most from their African equity investments.