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Back to basics: a contrarian look at cyclicals

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The current US economic expansion is the longest in the country's history, and for some time led a period of largely synchronised global growth. While economic indicators now express risk of a worldwide slowdown, we believe there are also opportunities for credit investors in certain cyclical companies. As such, we have taken a contrarian view on the basic materials sector, focusing on companies that have improved their balance sheets since the end of the last commodity cycle. In this issue of *Spectrum*, we consider which of these have the best prospects at this late stage of the macroeconomic cycle.

KEY POINTS

- The global economy is displaying late-cycle dynamics as economic indicators point to weakness. US-China trade tensions further cloud the picture, with a long-term resolution a distant possibility.
- But in risk lies opportunity: we have identified high-quality basic materials companies that could cope with slowing economic conditions.
- Certain mining and cement companies have strengthened their balance sheets since the end of the last commodity cycle, deleveraging and reducing their capital expenditure. We have invested selectively among them.

AMBER LIGHTS FLASHING

This July, the US economic expansion becomes the longest in the country's history, beating the bull run of 1990-2000. The economy has been growing at a steady pace since June 2009, when it began to emerge from the financial crisis, and has been instrumental in the global recovery. But indicators suggest that we are entering the latter stages of the global macroeconomic cycle. The downward trajectory of global purchasing-managers' indices, gauges of economic activity, is worrying, and follows declining GDP growth rates in developed and emerging markets (see figure 1). In addition, US-China trade tensions could undermine already-slowing global economic growth.

Figure 1. Slippery slope: global growth slows

Source: Markit/JP Morgan, IMF as at July 2019

SELECTIVELY BULLISH ON BASICS

How should credit investors respond? At this stage of the cycle, it is tempting to retreat into defensive industries. But we see opportunities among cyclical companies – particularly in several high-quality corporates in the basic materials sector, which includes steel, metals and mining, building materials and chemicals.

These companies benefited from fiscal stimulus provided by major central banks in the aftermath of the last crisis, and many have taken creditor-friendly steps to strengthen their balance sheets since the last commodity cycle ended almost five years ago. They have tended to prioritise debt repayments over shareholder dividends, strengthening their balance sheets. These dividends, when reinstated, are often subject to satisfactory levels of free cash flow, as well as the company passing leverage tests and meeting debt targets.

Capital-expenditure levels have trended lower post crisis, meaning that post-peak overcapacity levels should not be as high this time around. This has also freed up capital allocation for debt servicing. Combined, these actions are likely to result in more resilient balance sheets amid a downturn.

MINERS: LESSONS LEARNED

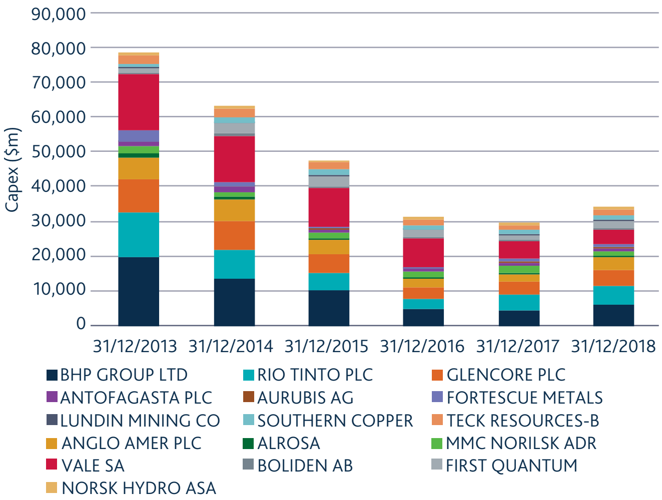
The mining industry tends to follow the global macroeconomic cycle, mirroring its booms and busts. As global growth slows, some worry about the volatile sector's health.

There are several reasons why the sector warrants a second look, however. Some mining companies are wary of over-extending themselves, following severe losses in previous commodity cycles. In the 2000s, miners splurged on projects to feed China's demand for materials. When Chinese growth slowed, the industry's profits plunged.[1]

Mindful of this, miners have been far more conservative in this cycle. Large mining-and-materials companies cut capital expenditure at the end of the last commodity cycle and have kept it below what it was five years ago (see figure 2). For instance, Anglo American's capital expenditure almost halved from 2014-2018 (see case study). This has eased concerns about oversupply in key commodity markets and freed cash for debt service.

[1] "Miners and investors bet and fret over latest commodities cycle," published by the FT on 3 January 2018.

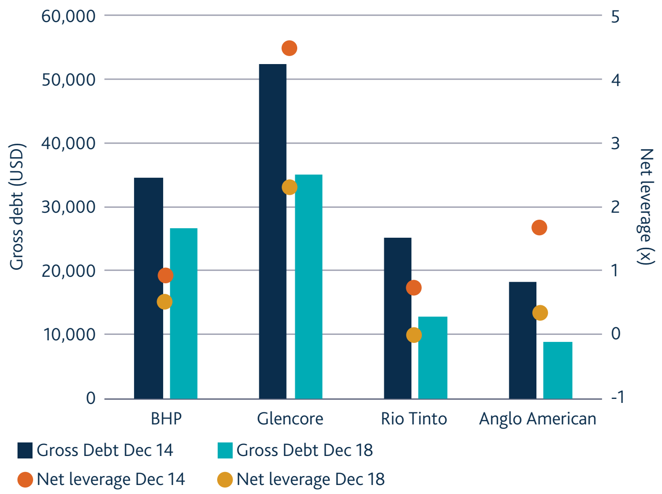
Figure 2. Sensible cyclicals: mining capex has returned to earth



Source: Bloomberg as at June 2019

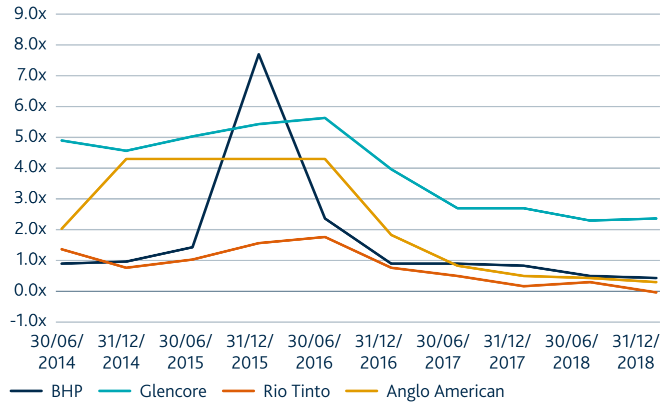
Mining firms' balance sheets also look healthier. Companies have deleveraged, supported by EBITDA growth and lower gross debt levels (see figures 3 and 4). Importantly, many of the companies we have invested in have some flexibility to redirect dividend payments towards debt servicing if required during a downturn.

Figure 3. Good as gold: reduction in mining firms' gross debt and leverage, 2014-2018



Source: Bloomberg, company filings, Hermes Credit as at June 2019

Figure 4. Major mining companies have cut net leverage to below 2014 levels



Source: Bloomberg, company filings, Hermes Credit as at June 2019

However, a surge in mergers and acquisitions (M&A) is a possible headwind. In the absence of new mining investment, deal-making is seen by some as a key path to growth. M&A activity in mining-and-metals industries rose by 51% last year, reaching a five-year peak.[2] This could be an indicator of weak capital discipline, potentially increasing leverage among companies and affecting their ability to service debt. We will continue to cautiously assess the valuations of any potential deals.

CASE STUDY: ANGLO AMERICAN IS A MODEL MINER

Anglo American is a London and Johannesburg-listed mining behemoth. Its recent financial policies are illustrative of how the mining industry has deleveraged and reallocated capital over the past five years.

The company has cut debt from $18.5bn in 2014 to less than half that in the latest financial year. Its net leverage ratio has also fallen from 1.8x to 0.4x over the same period (see figure 4), owing to its capital-allocation decisions. The company has also halved capital expenditure since 2014 and used cash to pay down debt. This has enabled it to regain investment-grade status and resume dividend payments, which exceeded $2bn last year.

CEMENT: SOLID DESPITE CRACKS

We also have a favourable view of the cement industry, despite softening macroeconomic sentiment. Global demand has been weakened by the slowdown in China, which consumes more than half of the world's supply.[3]

[2] "Global mining & metals M&A poised for continued growth in 2019," published by EY on 4 April 2019.
[3] "Global cement demand forecast to grow 1.5 percent in 2019," published by Reuters on 5 December 2018.

But there are positive dynamics for cement companies, too. Late-cycle economic stimulus can boost infrastructure activity and support demand for cement. The material has a low value-per-weight, which makes it hard to transport economically and means that production and demand are more localised. Trade-war concerns may not immediately affect cement as much as other industries, although they could have an impact on the health of important markets.

Like certain mining companies, some cement producers have strengthened their balance sheets. Cemex, the Mexican building-materials company, has achieved this by instigating a creditor-friendly financial policy (see case study).

CASE STUDY: CEMEX'S CONCRETE GOALS

Cemex has improved its credit profile by selling assets: it disposed $3.6bn-worth last year. It has also implemented cost-saving programmes to improve its operating performance.

The company generated $5.2bn in free cash flow over the past five years, which it has used to reduce debt. As a result, its net leverage ratio fell from 5.5x in 2013 to 3.8x last year. Its credit rating has also improved, rising from B- in 2012 to BB in 2017.

Cemex has communicated clear goals to the market and is committed to targeting an investment-grade profile.[4] It wants to use $1bn of free cash flow a year, in conjunction with asset sales, to reduce debt by $3.5bn and achieve a net leverage ratio of less than 3x by 2020.

ASSET SALES ARE CEMENTING RECOVERIES

Cemex is not the only company that has shed redundant assets. LaFargeHolcim raised 982m Swiss Francs from divesting its Malaysian business earlier this year; it is using the proceeds to reduce its net financial debt by 600m francs. Divesting assets in Indonesia, Singapore and the Philippines will also help it reduce its net leverage by 0.6x. In March, both S&P and Moody's upgraded its outlook from negative to stable. Despite this progress, we take a cautious view of LaFargeHolcim. Its record on environmental, social and governance issues is questionable – there is an ongoing investigation into protection payments it allegedly made to armed groups in Syria.[5]

Heidelberg Cement also sold assets valued €600m in 2018, along with €220m-worth in the first quarter of this year. It claims that this 'has practically no impact on EBITDA'.[6] It also matched its $1.4bn dividend with a debt payment of the same amount. This helped reduce its net debt-to-EBITDA ratio from 4.0x in 2009 to 2.7x last year. The firm has stated that it is 'pulling all levers' to support an investment-grade rating.[7]

SECTORS AT RISK

While many basics companies look promising, we remain selective: the theme of improved capital discipline is not universal. For instance, we have a cautious view of petrochemical companies. Rising low-cost shale-gas production has encouraged an increase in the supply of petrochemicals, leading to overcapacity just as signs of weakening global growth have emerged.

There is also overcapacity in the US steel market. Steel prices rose briefly last year after President Donald Trump imposed Section 232 tariffs on imports, causing concern about supply shortages. But the supply shock did not materialise. Instead, domestic production rose last year and imports failed to diminish enough to offset the extra supply. Expectation that supply would increase even more exerted further pressure on steel prices, which fell back to 2017 levels.

Last year's rise in prices boosted companies' cash flows. As a result, many of them announced large capital-expenditure plans for the next two-to-three years, aimed at expanding capacity. These plans commit cash flows over multiple years meaning companies have little flexibility over what they use future cash flow for. European steel firms also face problems. Shipments that previously targeted the US have been redirected to Europe, while the stalling auto sector has also hit demand.

Nonetheless, we are reviewing the US and European steel sectors. The credit spreads of some companies have underperformed over the past few months and the new pricing of their debt better reflect the decline in fundamentals. Recent capacity cuts by some producers indicate that some capital discipline may be returning to the market, which is encouraging, but we continue to exercise caution.

LATE-CYCLE CONTRARIANISM

The most attractive basics companies are those that have exercised capital discipline in the years since the last commodity-price crash. Some of these exist in the mining and cement sectors, and have successfully reallocated capital, deleveraging and prioritising balance-sheet strength over expansion. They have reinstated dividends without threatening their credit profiles, but have the flexibility to redirect these towards debt repayments should the economic outlook darken. We are confident in our contrarian approach to basic materials: investing selectively in cyclicals, late in the cycle.

[4] Cemex, 2018 Integrated Report, 28 March 2019.
[5] "French court of appeal to rule on LaFargeHolcim terrorism charges in October 2019," published by Global Cement on 21 June 2019.
[6] HeidelbergCement, 2019 first quarter results presentation, 9 May 2019.
[7] HeidelbergCement, 2018 full year results presentation, 21 March 2019.

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