Eagle Materials:

engagement commentary

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Federated Hermes Limited

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ENGAGEMENT COMMENTARY:

Eagle Materials

In a nutshell

Dallas-based Eagle Materials is a leading US manufacturer of cement and gypsum wallboard – essential products for construction and infrastructure projects across the United States. The company operates eight cement plants (including one via a joint venture) producing approximately 6% of the total US clinker[1] capacity.

At a glance:

US$8.3bn

Market capitalisation (May 2024)

US$2.26bn

Revenue (Financial year 2024)

Investment case

- Low-cost producer of in-demand commodity products in an industry with significant production capacity constraints.
- Consistent record of credible management and execution.
- The push to upgrade US infrastructure provides mid-term certainty over demand for its products.
- The production of cement is carbon intensive. However, the next decade will see significant investment in cement-reliant infrastructure – such as the foundations for wind farms – to support efforts to achieve net zero.

Theory of change

Cement is the key ingredient in concrete, which is the world's most common building material. It is also the most used material in the world after water[2]. **The manufacture of cement accounts for 1.25% of CO_2 emissions in the US**[3] and demand is projected to increase.

The direct CO_2 intensity of cement production increased 1.8% per year in the period 2015-2020, according to the International Energy Agency (IEA)[4] – in contrast, a 4% annual decline in direct CO_2 intensity is required to meet the IEA's Net Zero Emissions by 2050 Scenario.

Eagle Materials clinker capacity is approximately 6.7 million tons, which represents about 6% of total US clinker capacity[5]. Indeed, Eagle is the country's second-largest domestic producer of cement (the US$3.2bn buyout of Cementos Argos by Summit Materials this year made it the largest US-only producer).

[1] Clinker is the backbone of cement production. It is essentially a mix of limestone and minerals that have been heated in a kiln and have been transformed by this heat.

[2] About Cement & Concrete : GCCA (gccassociation.org).

[3] US Environmental Protection Agency (EPA) carbon emissions data.

[4] Cement – Analysis – IEA.

[5] Company reports.

Eagle Materials has a proud history of efficient production, as illustrated by its industry-leading operating margins. Nonetheless, **a marked improvement is still required – in terms of its own production and across the industry at large – if this essential commodity is to support rather than hinder national and global efforts to achieve net-zero emissions**.

The company is well placed to drive this change. It is implementing initiatives to reduce its CO_2 output, as well as supporting efforts to develop the technology that will ultimately be required.

Cement production – the basics and the opportunities

It is important to acknowledge that cement manufacturing is unavoidably carbon intensive. The transformation of the calcium carbonate in limestone into calcium oxide is a vital step to produce clinker – but it is responsible for approximately 60% of total cement manufacturing emissions[6].

At the present time, there is no viable alternative in industrial cement manufacturing. Therefore, the commercialisation of carbon capture technology is critical if the industry is to achieve its net-zero ambitions.

Net zero

Global and regional industry associations – including the Global Cement and Concrete Association (GCCA)[7] and the Portland Cement Association[8] – have published a series of roadmaps outlining how the industry can move to net zero by 2050.

The GCCA Net Zero Roadmap argues that 2020-2030 is the decade for action. As the IEA has noted, the rise in CO_2 intensity of production between 2015 and 2020 means that sharper focus is needed in two particular areas:

i) reducing the clinker-to-cement ratio (including through greater uptake of blended cements) and

ii) deploying innovative technologies – including carbon capture, utilisation and storage technology (CCUS).

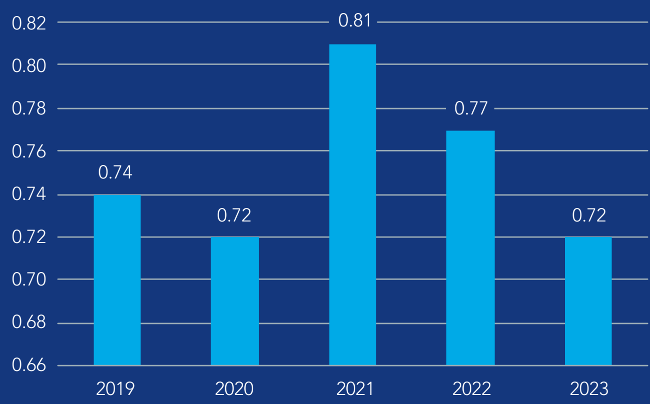
Practice of change

Over the period of our investment, we have met with Eagle's management on numerous occasions to discuss the company's decarbonisation efforts, along with other matters of interest.

22 ESG interactions since the beginning of 2018

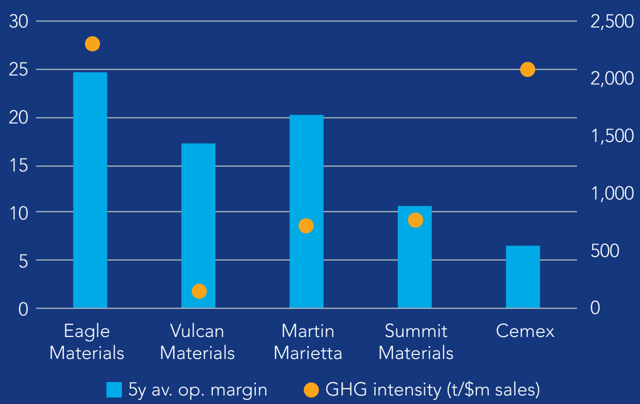
While much more progress is needed, the company has already delivered meaningful improvements in both disclosures and practices, and work is underway to make further improvements in the years ahead.

Figure 1: Carbon intensity of production MT CO_2e/MT of cementitious product



Source: Eagle Materials 2023 ESG report.

Figure 2: Five-year average operating margin and greenhouse gas intensity vs. peers



Source: Company reports/Bloomberg.

[6] IEA – Technology Roadmap—Low-Carbon Transition in the Cement Industry (IEA, 2018).
[7] GCCA-Concrete-Future-Roadmap-Document-AW.pdf (gccassociation.org).
[8] pca-roadmap-to-carbon-neutrality_10_10_21_final.pdf (cement.org).

The company's carbon intensity of production, as of FY 2023, was 0.72 MT CO_2 / MT of cement[9]. The fact this figure is higher than international peers speaks more to the stricter standards around clinker substitution in the US than anything else. In comparison to many domestic cement-producing peers, the company's carbon intensity looks much more favourable[10]. Nonetheless, there is still significant scope for more progress. It is important to note that the company does not hide from this challenge (as we summarise below).

The jump in carbon intensity of production in FY 2021 and subsequent recovery in the years since (see Figure 1) is the result of Eagle Material's acquisition of the Kosmos cement plant in Kentucky. Eagle has overseen a 10% improvement in the carbon intensity of the plant while also adding more than 10% in capacity[11] – illustrating its commitment to environmentally efficient production.

The company has a goal of a 20% reduction in carbon intensity by 2030 vs. a 2011 baseline. While welcome, this goal is short of what is required. It also significantly underrepresents what Eagle is already set to deliver over the period.

Figure 3 illustrates our estimate on the likely direction of travel of Eagle's carbon intensity until 2030. It reflects not just the emissions intensity reductions likely to be achieved via the adoption of lower-clinker cement; but also the new supplementary cementitious material capacity being established; and the upgrade to its plant in Laramie, Wyoming.

Figure 3: Carbon intensity per unit of production

Source: Federated Hermes estimate/company disclosures.

Looking ahead, there are three principal drivers for cement decarbonisation:

1 Increased use of alternative fuels

2 Reducing clinker content

3 CCUS technology and infrastructure development

1. Optimising efficiency of existing production including the use of alternative fuels

Fossil fuels continue to provide the majority of energy in the cement sector – constituting 90% of energy usage in 2022[12]. In the US, the industry's fuel mix includes 60% coal and petcoke at the present time, and the industry wants to cut that amount by a factor of five with the goal of no more than 10% use by 2050[13].

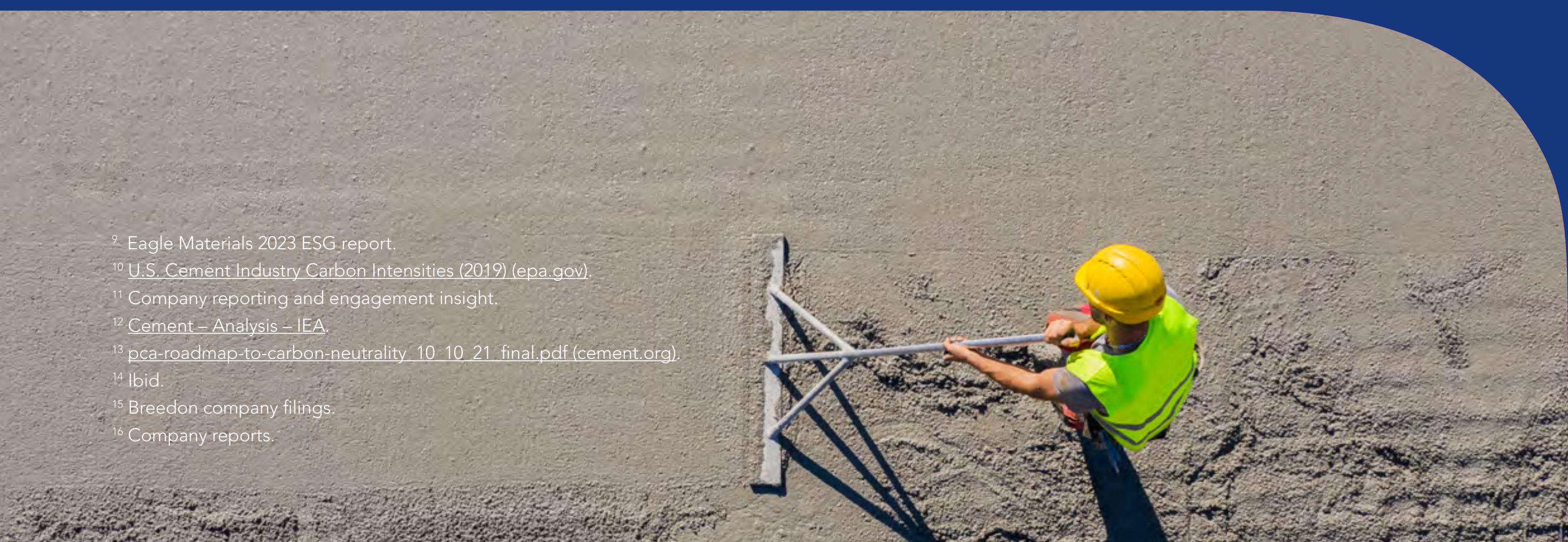
In Europe, alternative fuels already often exceed 60% of total fuel use[14]. Indeed, one of the two cement plants run by British cement producer Breedon (in which we are invested) alternative fuel usage often exceeds 90%. In the US by contrast, alternative fuel use is just 14%[15].

In most cases, cement plants are already equipped to use alternative fuels at far higher levels than is current practice in the US. As a result, there is a significant opportunity to realise environmental gains in the near term. Eagle's management has acknowledged the need to pursue investments to increase its overall alternative fuel utilisation.

Today, Eagle Materials utilises natural gas, and alternative fuels at

4 of its cement plants

In May 2024, the company announced **US$430m of capital expenditure to modernise its Laramie, Wyoming cement plant**. The investment will increase the plant's capacity by 50%, and will also enable the use of alternative fuels. The result will be **25% lower manufacturing costs and a 20% lower carbon intensity of production**[16].



9. Eagle Materials 2023 ESG report.
10 U.S. Cement Industry Carbon Intensities (2019) (epa.gov).
11 Company reporting and engagement insight.
12 Cement – Analysis – IEA.
13 pca-roadmap-to-carbon-neutrality_10_10_21_final.pdf (cement.org).
14 Ibid.
15 Breedon company filings.
16 Company reports.

2. Reducing clinker content – ensuring finite resources go further

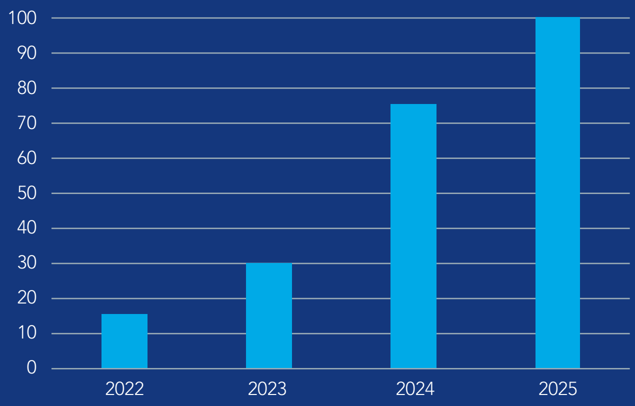
Central to efforts to reduce the carbon intensity of cement (and as a result concrete) is reducing the reliance on clinker itself.

Ordinary Portland cement contains up to 95% clinker. While the average clinker substitution rate in Europe is well over 25%, according to the European Cement Association, it is only in the last few years that Portland limestone cement (PLC) has been accepted for use by organisations such as the various departments for transportation in the US.

Although still far short of clinker substitution levels in Europe, **PLC allows for up to 15% limestone content and in turn achieves a 10% reduction in the carbon footprint**. Moreover, the product is also cheaper to produce, because it requires lower clinker content. PLC offers that rare combination of being positive from an environmental and economic point of view.

Eagle Materials have made significant progress over the last few years in moving from traditional Portland cement to Portland limestone cement – essentially making its clinker go further.

Figure 4: Portland limestone cement as % of sales



Source: Company reports

At the end of financial year 2024,

75% of Eagle's cement sales were for the less carbon-intensive PLC (or other blended cement products).

We expect this figure to rise to 100% by the end of 2025.

In addition to lowering the clinker content of cement, the use of supplementary cementitious materials (SCM) can further lower the carbon intensity of cement and concrete.

Traditionally, industrial byproducts such as blast furnace slag (co-product in the manufacture of iron) and fly ash (byproduct of coal combustion in electric power generation) have been used – however, they are both in declining supply.

Eagle is investing in its own slag grinding facility to increase its supply of cementitious alternatives (500,000 tonnes by summer 2024). There is nonetheless a need to find more low-carbon alternatives.

Therefore, it is positive to note that in December 2023, **Eagle reached an exclusive agreement with Terra CO2** – winner of the 2024 CleanTech Breakthrough award for 'Decarbonisation Solution of the Year'.

Terra CO2 is a producer of a scalable low-carbon supplementary cementitious material. What is exciting about Terra CO2's technology is that it allows for the conversion of inexpensive and abundant local feedstocks – such as the wide variety of silicate rocks at existing aggregate mines – into high-performing and therefore cost-competitive cementitious materials.

The agreements grant Eagle Materials an exclusive right to build and operate three plants that produce low-carbon SCM. While two years away from production, once developed and fully scaled, each plant is expected to have the potential to produce approximately 240,000 tonnes of SCM per year – in aggregate the equivalent of a brand-new cement plant – and the **Terra CO2 supplementary cementitious material could substitute between 20% and 40% of clinker content**[17].

3. Carbon Capture

Finally, carbon capture will be critical to reduce the sector's emissions. It is carbon capture that will need to do the heavy lifting with respect to allowing the industry to achieve net zero.

While dozens of carbon capture technologies are currently being researched and tested at cement plants throughout the world, there are, at present, no commercial scale carbon capture installations at any cement plant in the US.

In 2021, we welcomed **Eagle's announcement that it was to collaborate with Chart Industries (in which we are also invested) to test its Cryogenic Carbon Capture (CCC) technology**. The technology has the potential to reduce carbon emissions by 90-99%[18] at a much lower cost than alternative carbon capture technologies, offering hope for potential commercial scalability. As of 2024, the piloting of this technology remains ongoing and another year of testing is planned – but the early indications are positive.

[17] Eagle Materials press release.
[18] Ibid.

Next steps

a. Establish an alternative fuel roadmap.

In the short term, management should prioritise what it has the capacity to control, namely ensuring that its cement plants are operating as efficiently as is practicable, including from a carbon perspective.

We welcomed the announcement in May 2024 that the company will invest in its Mountain Cement plant in Wyoming, and upgrade the kiln to enable the use of alternative fuels. We also welcome efforts to attain permits for alternative fuel use at other sites. Nonetheless, we note that other kilns also need similar upgrades and total aggregate alternative fuel use is low.

We therefore encourage the company to create an alternative fuel roadmap. We specifically encourage the company to set an aggregate target for alternative fuel use which would require each of its eight (seven owned and one joint venture) cement plants to report on the level of alternative fuel utilisation, alongside associated investment plans and timelines for increasing utilisation of alternative fuels.

b. A revamped 2030 emissions reduction target.

When it was established, the company's 2030 emissions intensity target was a positive step. However, it really just captures the gains realised via the conversion to Portland limestone, and blended cements.

We encourage the company to establish a revised and more ambitious target which covers all of its Scope 1+2 emissions (recognising that 90% of emissions are associated with the cement business). A recalibrated near-term target and accompanying strategy would focus on emissions improvements which remain in the control of management.

c. Establish a science-based target

We sympathise with the company's reticence to set an explicit long-term target given the attainment is beyond its own control – relying as it does on the commercial scaling of carbon capture technology. Nonetheless, we encourage the company to proceed with setting such a target and suggest it should also cover its Scope 3 emissions from purchased clinker. Establishing such a target (and ideally submitting it for approval by the Science-Based Target initiative) would be a vital step in highlighting to policymakers and investors the company's commitment to playing its full part in achieving the shared aim. It is also important to communicate to both parties, in particular policymakers, those factors such as regulatory action and technology development (including fiscal support needed) that the company is dependent upon if net zero is to be achieved.

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