HSBC Global Research

Building Materials

Light at the end of the Italian tunnel

EQUITIES
BUILDING MATERIALS

EUROPE

- Rome reverse roadshow reiterates prospects for further consolidation and modest volume upturn
- Italy recovery supports cash upturns at Buzzi and HeidelebergCement in particular
- Reiterate Buy on Buzzi (TP EUR29) and HeidelbergCement (TP EUR102)

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Italian upturn underway

Following our Rome reverse roadshow on 4-5 October 2017 we are even more comfortable with our forecasts for Buzzi and HeidelbergCement in Italy where we expect them to begin reversing 10 years of EBITDA declines and inadequate returns. These unchanged forecasts increase 2016 group EBITDA by 4% for Buzzi and by 1% for HeidelebergCement in the three years to 2019.

Our meetings and plant tour of Buzzi, Cementir, Salini-Impregilo and The Italian Cement Association support our forecast for the residential sector to start a recovery in volume at a CAGR of 3% to 2019, albeit without much help from the most significant civil engineering end market.

Management teams at the companies we visited welcome the consolidation of Italian capacity in the last 18 months as they believe it prepares the ground for a meaningful pickup in cement prices, which we forecast at a CAGR of 4% to 2019, to a level that would still be amongst the lowest in Europe.

In this note, we present a scenario where further consolidation in Italy lifts cement price growth to a 7% CAGR to 2019 and capacity utilisation to 64-80%. This in turn would enhance the increments to 2016 group EBITDA to 10% for Buzzi and 2% for HeidelbergCement in the three years to 2019. Our base case already assumes that Italy will represent 1% of group EBITDA by 2019 for both companies which in a scenario of further consolidation rises to 4% and 2% of 2019e group EBITDA.

We are forecasting in our base case a substantial rise in free cash flow of 67-255% for HeidelbergCement and Buzzi in the three years to 2019, leading to a free cash flow yield of 11.5-8% in 2019.

Key changes to ratings and estimates

Company	Ticker	Currency	Current price	TP	Rating	Upside/ downside	Market cap (USDm)	EV/EBITDA 2019e	ROIC 2019e	FCF yield 2019e	Dividend yield 2019e
Buzzi	BZU IM	EUR	22.7	29	Buy	27.6%	5,039	6.4	8.2%	8.0%	3.1%
HeidelbergCement	HEI GY	EUR	84.9	102	Buy	20.1%	19,775	6.5	7.2%	11.5%	5.4%

Source: Thomson Reuters Datastream, HSBC estimates. Priced as of close at 9 October 2017

Improvement in Italy EBITDA

- Italy volume upturn finally underway
- Consolidation underway should spark a recovery in cement prices
- A scenario of more consolidation would raise recovery prospects even further

Improvement in Italy EBITDA in store

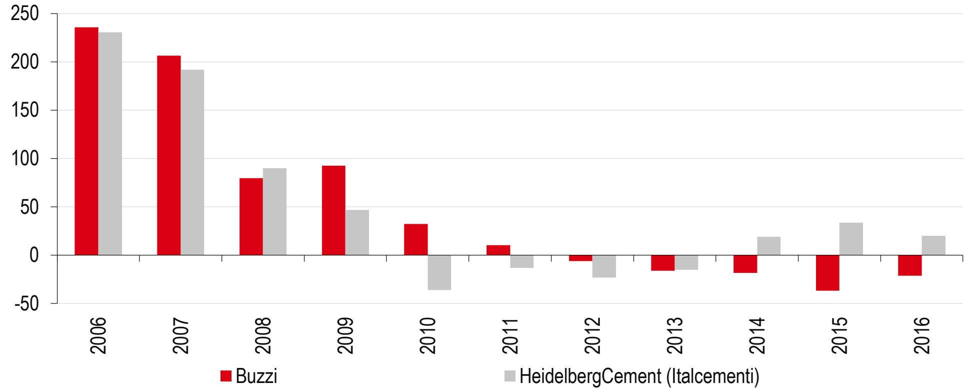
The reverse roadshow that we hosted in Rome on 4-5 October confirmed that the Italian cement producers HeidelbergCement and Buzzi can look forward to improved profitability and in Buzzi's case, to move finally to a positive EBITDA, after steep declines since the onset of crisis in 2008.

LafargeHolcim also benefits from this Italy upturn. Italy comprised 1% of group cement capacity at December 2016, which is grouped into our Europe EBITDA forecasts with specific Italy volume and price inputs.

The key messages from the companies we visited and our conclusions from the reverse roadshow are as follows:

- Residential demand has finally picked-up and is set to be the driver of an upturn in Italian cement production (and consumption). We forecast a 2% increase in cement consumption in 2017, accelerating to 3% per annum in 2018-19.
- The consolidation of the Italian cement industry in the last eighteen months has sparked the prospect of a sharp recovery in Italian cement prices. We are forecasting a 13% increase 2019 on 2016, from a country average level of EUR52 per ton in 2016.
- As we argued in prior notes, we expect this consolidation to continue, which would likely increase cement prices further, raising utilisation rates through plant closures and redistribution of volume to the most efficient plants. We present this outcome as a scenario in exhibit 4.

Exhibit 1: Both Buzzi and HeidelebergCement (Italcementi) in Italy have lost more than EUR200m of EBITDA in Italy in the last 10 years (EURm)



Source: Company data

Exhibit 2: HSBC's Italy cement volume and price forecasts

	2016	2017e	2018e	2019e
Base case				
National average cement price (EUR per ton)	52.0	53.5	55.5	58.5
Price increase (EUR)		1.5	2.0	3.0
Price growth		3%	4%	5%
Cement volume growth		2%	3%	3%
Further consolidation scenario				
National average cement price (EUR)	52.0	53.5	57.5	64.5
Price increase (EUR)		1.5	4	7
Price growth		3%	7%	12%
Cement volume growth		2%	3%	3%

Source: HSBC estimates

Our base case forecasts (exhibit 3) show the improvement to a modest positive EBITDA for Buzzi by 2019 whilst HeidelbergCement becomes EBIT neutral. We do not include the agreed acquisition of Cementir in our estimates for HeidelbergCement. Our forecasts are based on the cement volume and price base case assumptions in exhibit 2.

Exhibit 3: Base case Italy earnings

EURm	2016	2017e	2018e	2019e
EBITDA (EURm)				
Buzzi	-21	-13	-2	10
HeidelbergCement	20	30	40	50
EBITDA margin				
Buzzi	-5.6%	-3.4%	-0.5%	2.4%
HeidelbergCement	3.5%	5.0%	6.3%	7.2%
Depreciation				
Buzzi	-29	-29	-29	-29
HeidelbergCement	-50	-50	-50	-50
EBIT				
Buzzi	-51	-43	-32	-19
HeidelbergCement	-30	-20	-10	0
Capacity utilisation				
Buzzi	50%	51%	53%	54%
HeidelbergCement	64%	66%	68%	70%

Note: HeidelbergCement 2016 EBITDA, EBITDA margin and EBITs are estimated by HSBC
Source: Company data, HSBC estimates

We believe that these returns in our base are unsatisfactory for both companies, so we expect them to pursue further consolidation of the Italian cement industry. We show in Exhibit 4 our EBITDA estimates in the event of HeidelbergCement completing the Cementir acquisition and further small producer consolidation, allowing incremental price rises and increases in capacity utilisation. The utilisation is high for HeidelbergCement with the scope to shut inefficient Cementir capacity.

Exhibit 4: Further consolidation scenario earnings

EURm	2016	2017e	2018e	2019e
EBITDA				
Buzzi	-21	-13	5	33
HeidelbergCement	20	30	49	88
EBITDA margin				
Buzzi	-5.6%	-3.4%	1.2%	7.7%
HeidelbergCement	3.5%	5.0%	7.7%	12.7%
Capacity utilisation				
Buzzi	50%	51%	58%	64%
HeidelbergCement	64%	66%	73%	80%
Depreciation				
Buzzi	-29	-29	-29	-29
HeidelbergCement	-50	-50	-50	-50
EBIT				
Buzzi	-51	-43	-25	4
HeidelbergCement	-20	-20	-1	38

Note: HeidelbergCement 2016 EBITDA, EBITDA margin and EBITs are estimated by HSBC
Source: Company data, HSBC estimates

The impact of these forecasts is that Italy EBITDA in our base and further consolidation scenarios for the two companies:

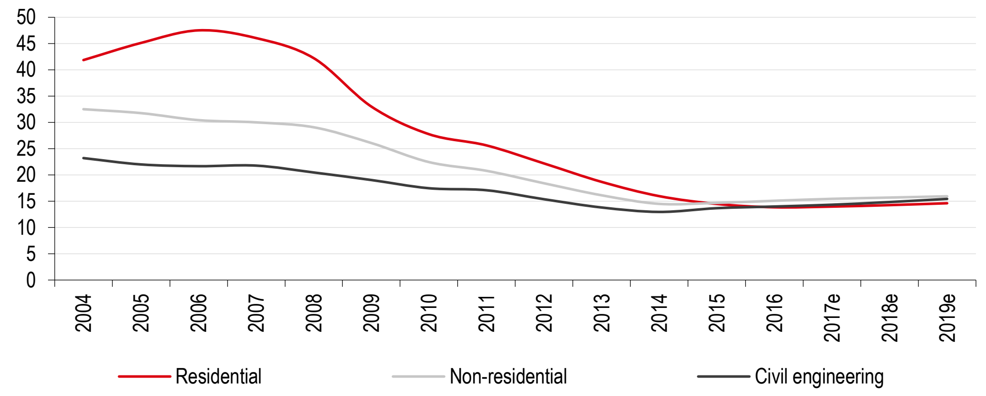
- Swings positive for Buzzi by EUR30m and EUR54m respectively, growing Group EBITDA by 6% and 10% respectively 2019 on 2016, representing 1% of Group EBITDA in 2019 in our base case and 4% in our further consolidation scenario.
- Rises by EUR30m and EUR68m respectively for HeidelbergCement, growing Group EBITDA by 1% and 2% 2019 on 2016, representing 1% of Group EBITDA in 2019 in our base case and 2% in our further consolidation scenario.

Forecasting only a limited recovery in cement volume through to 2019

60% fall in cement consumption since 2006

We are forecasting Italy cement volumes to rise 2% in 2017 and 3% per annum in 2018-19 (exhibit 2). Italian cement production has declined every year since 2006 to a cumulative 60% reduction to 2016 (exhibit 6). This contraction is largely due to the sharp 71% fall in new residential construction output and 50% fall in non-residential (exhibit 5) with the civil engineering/infrastructure end-market more resilient (new activity down 35% in the same period). This has left the infrastructure as the most significant source of cement consumption with a 65% share.

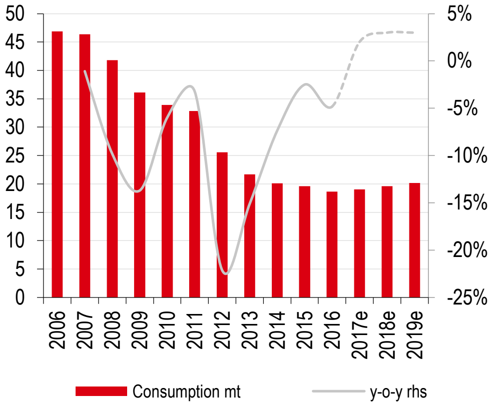
Exhibit 5: Italy new construction output has fallen 57% from the peak of 2006, led by residential down 71% (EURbn)



Source: Euroconstruct, HSBC estimates

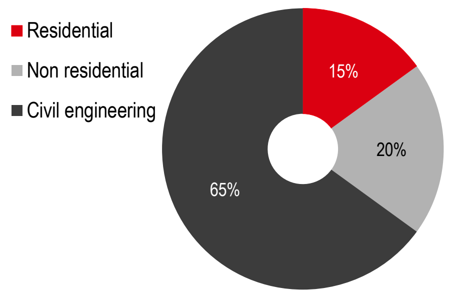
Cement consumption was broadly evenly split between the three end-markets in 2006 yet residential share has fallen to 15% of end demand and non-residential to 20% following their relatively sharper declines.

Exhibit 6: Cement demand is down 60% from the 2006 peak



Source: AITEC, HSBC estimates

Exhibit 7: Residential share in end-market demand has fallen to 15% in 2016



Source: HSBC estimate

Limited prospect of infrastructure upturn

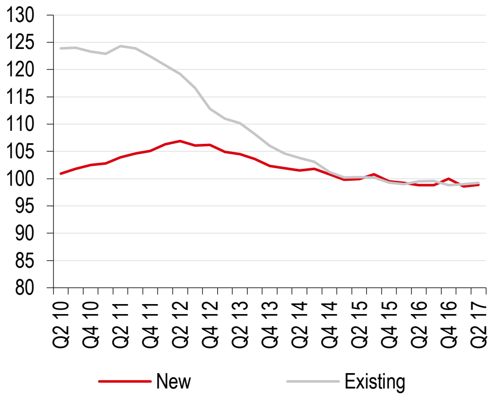
The outlook for government spending on infrastructure is key to the prospects for volume growth, with the messages on the subject universally muted from the companies we visited.

The Government debt to GDP ratio at 133% at the end of 2016 sets a framework of limited scope for an acceleration in infrastructure spending. Nevertheless, the recurrent theme in the company visits in Rome, was that even when monies are budgeted, the often transitory nature of the political system, coupled with a bureaucratic system stymies approvals and infrastructure activity. The next general election is due by May 2018, so there seems little prospect of impetus from the most significant subsector in 2017-18 at least.

Residential rally is underway

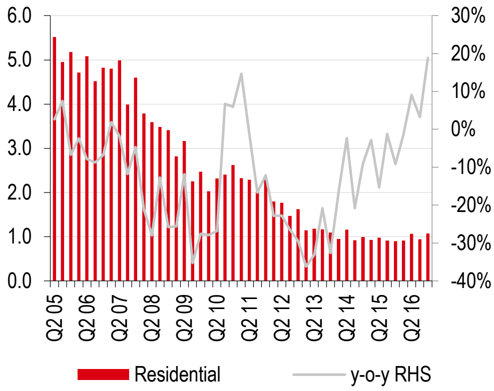
There was a broad consensus from the companies visited that the residential market has troughed and we are forecasting a 5% upturn in new activity in 2017, accelerating to 10% in 2018 and 15% in 2019 on our expectation. Existing home prices have been stagnant since 2015, having fallen 20% between 2011 and 2014. The market evidence from the real estate division of the Caltagirone Group that we visited was that sales of homes have picked up significantly in their Rome market, by fourfold H1 2017 on H1 2016, albeit off a low base.

Exhibit 8: Existing house prices are down 20% from the 2010 levels (2005=100)



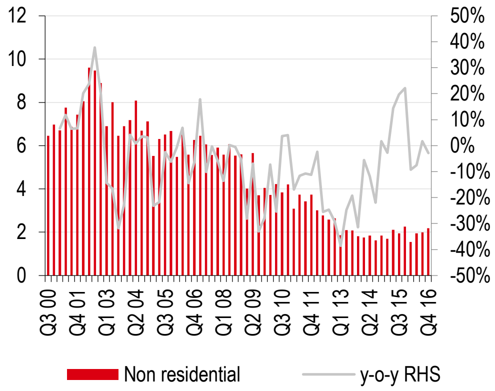
Source: Istat

Exhibit 9: Residential permits have fallen 80% from the 2005 levels (sqfm)



Source: Istat

Exhibit 10…and non-residential permits are down 70% from 2005 levels (sqfm)



Source: Istat

The Caltagirone Group are unlikely to be representative of the wider Italian market as they are well capitalised and have inventory to sell, which is not widely the case with a sharp reduction in the number of developers in the ten years since the start of the crisis.

Cement volumes in the residential end market should also be modestly supported by the “earthquake bonus” which was introduced in January 2017 and has to date had a negligible impact. This is due to the complications of the scheme, which provide for a fiscal incentive of 80% of the expenditure within five years.

Non-residential demand to rise modestly with GDP

We expect the non -residential end-market to broadly track GDP growth at an expansion of 1% in 2017 and 2% in 2018, which is in line with our cement volume forecasts.

Discussions of the non-residential outlook with the companies that we visited confirmed that there is little appetite for any pick-up in office and retail development outside of Milan, with surplus space available in most towns and a longer duration of GDP growth required to kick-start a meaningful increase in investment.

The CFO of Salini-Impregilo, a construction contractor company, outlined that Milan was the only city in Italy in which the company was still active, which has benefitted from expansion of the business district and a number of international banks and investment institutions had moved out to the new developments.

Consolidation driving cement prices higher

The outlook for a rally in cement prices has improved significantly following the long awaited consolidation in the last eighteen months. This includes the September 2017 announced amalgamation of HeidelbergCement, the market leader with the previous fourth and fifth largest producers, Cementir and Saaci that came together when the former bought the latter in July 2016 (exhibit 11).

These two acquisitions and Buzzi’s acquisition of Cementizillo in June 2017 account for 17% of installed cement capacity.

These recent consolidation transactions follow the moth-balling of 10mt plant by the larger groups in 2012-13, which was the first response to the new post-crisis volumes

Exhibit 11: Italy cement consolidation transactions

Date	Aquirer	Target	Targer cement capacity (mt)	EV (EURm)
29-Jul-16	Cementir	Sacci	3.0	125
16-Jun-17	Buzzi	Cementizillo	2.0	37.5
19-Sep-17	HeidelbergCement	Cementir	6.8	315

Source: Company data, HSBC

Exhibit 12: Industry closed/moth-balled 10mt capacity in 2012-13 (total for Italy)

Company	mt	Date	Comments
Italcementi			
Pontassieve	0.2	Q3 2012	Grinding station sold
Vibo Valentia	0.8	Q3 2012	Kiln closed in Q3 12 and grinding mothballed in H2 13
Porto Empedocle	0.9	Q3 2012	Kiln closed in Q3 12 and grinding mothballed in H2 13
Broni	0.4	H1 2013	Grinding station closed
Monselice	1.5	H1 2013	Integrated plant closed
Trieste	0.5	H1 2013	Grinding station closed
Scafa	0.4	H2 2013	Integrated plant mothballed
Total Italcementi	**4.6**		
Buzzi Unicem			
2013	1.3	H1 2013	
2013	0.4	H2 2013	
Holcim - Merone	2.0	Q4 2012	Kiln closed
Cementir	1.4	H2 2013	Integrated plant mothballed
Total	**9.7**		

Source: Company data, Cemweek, HSBC estimate

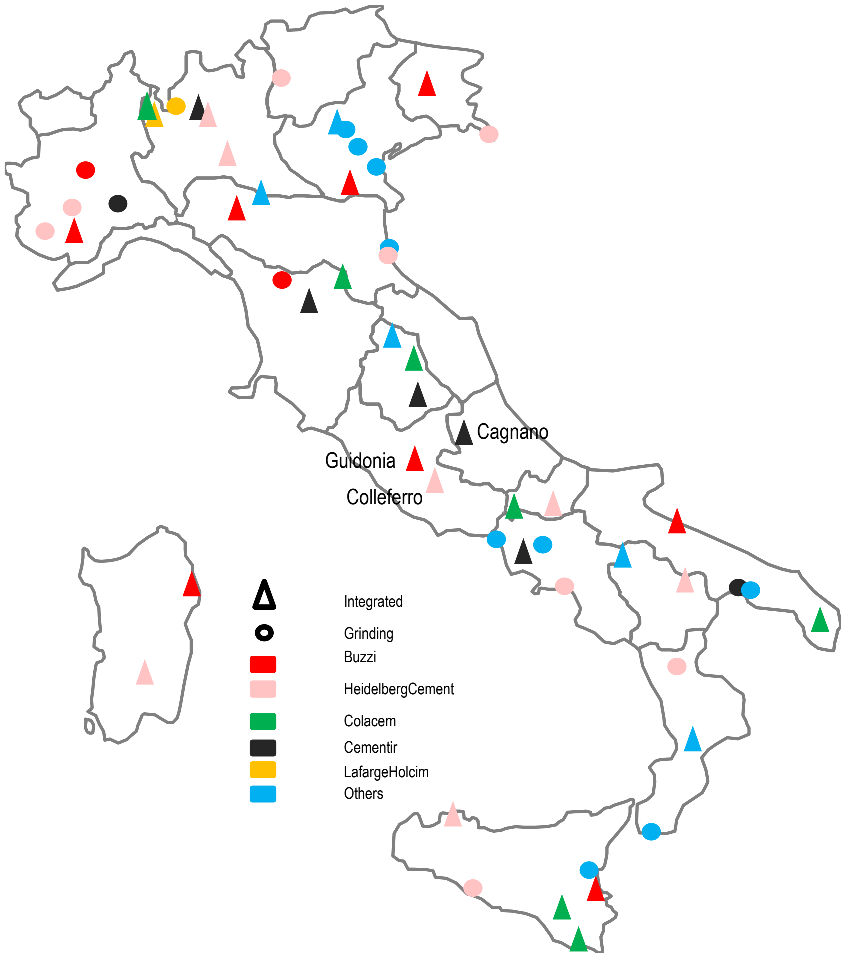
Exhibit 13 shows the cement plant ownership of the four largest players (assuming antitrust approval of HeidelberCement's Cementir acquisition) accounting for just under 75% of cement capacity in Italy. The 52mt cement capacity includes 10mt of mothballed capacity, which reduces the effective capacity, including mothballed and grinding to 33mt. Excluding mothballed capacity, the concentration ownership of the top four, increases to 76%.

Exhibit 13:Italy cement plants by company capacity

	Buzzi	HeidelbergCement	Colacem	Cementir	LafargeHolcim	Others	Total
North	5	7	1	2	2	6	23
Central	2	1	2	2	0	1	8
South	1	4	2	3	0	6	16
Islands	2	3	2	0	0	2	9
No of plants	**10**	**15**	**7**	**7**	**2**	**15**	**56**
Capacity (mt) 2016	**10.4**	**11.1**	**8.2**	**6.8**	**3.7**	**11.8**	**52.0**
% of capacity	**20%**	**21%**	**16%**	**13%**	**7%**	**23%**	

Note: HeidelbergCement and Buzzi figures excludes respective acquisition of Cementir and Cementizillo
Source: Company data, HSBC estimates

Exhibit 14: Italy cement plant locations



Source: HSBC estimates

Amongst the other producers, Cementi G Rossi accounts for the next largest proportion of 7% capacity.

Forecasting price rises on consolidation to date

The prospects for a recovery in cement prices from a range of EUR45 to EUR62 (highest in the north and lowest in the central and southern regions) have improved with the consolidation that has been shaken out by seven years of losses for most of the industry.

The companies we visited are optimistic that the EUR1-2 rise in Q2 2017 will be consolidated by the end of the year, albeit that this is approximately only half the rise that was first achieved on the announcement.

The key to the absence of cement price growth in recent years has been the EU Emissions Trading System for carbon that requires a cement plant to operate at a minimum utilisation of fifty percent of capacity. This has kept production at levels slightly in excess of domestic demand with a 1-2m tonne level of exports, so that carbon permits are secured. The carbon trading system allowances are currently being reviewed effective from 2020 which could be the trigger for further consolidation.

Valuation and risks

		Valuation	Risks
Buzzi Unicem BZU IM **Buy**	Current price: **EUR22.72** Target price: **EUR29** Up/downside: **27.6%**	We derive our EUR29 target price using an 8.0x 1-year forward target EV/EBITDA multiple, before present valuing back at the cost of capital (6.3%). Our WACC is derived using a cost of debt of 4.5% and blended cost of equity at 8.4%, using a beta of 1.0 and an ERP of 6.0. Our EUR29 target price implies 27.6% upside and we rate the stock Buy as we believe the European business, especially Italy, has growth potential beyond our forecast horizon.	Downside risks: Our forecasts of stabilising Italian cement demand and prices fail to materialise and the US and wider European recovery stall or decelerate below our forecasts.
HeidelbergCement HEI DE **Buy**	Current price: **EUR84.91** Target price: **EUR102** Up/downside: **20.1%**	We derive our EUR102 target price using an 8.5x 1-year forward target EV/EBITDA multiple due to higher risks to our Indonesia forecasts, before present valuing back at the cost of capital (7.1%) from the end of 2018. Our WACC is derived using a cost of debt of 4.5% and blended cost of equity at 9.1%, using a beta of 1.1 and an ERP of 6.0%. Our EUR102 target price implies 20.1% upside and we rate the stock Buy as we believe the US and Indonesia have growth potential beyond our forecast horizon.	Downside risks: The volume recovery that we forecast in Indonesia fails to materialise. US and European recovery stall or decelerate below our forecasts. Italcementi integration synergy gains are lower than guidance.

Priced at 9 October 2017
Source: HSBC estimates

Disclosure appendix

Analyst Certification

The following analyst(s), economist(s), or strategist(s) who is(are) primarily responsible for this report, including any analyst(s) whose name(s) appear(s) as author of an individual section or sections of the report and any analyst(s) named as the covering analyst(s) of a subsidiary company in a sum-of-the-parts valuation certifies(y) that the opinion(s) on the subject security(ies) or issuer(s), any views or forecasts expressed in the section(s) of which such individual(s) is(are) named as author(s), and any other views or forecasts expressed herein, including any views expressed on the back page of the research report, accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: John Fraser-Andrews and Brijesh Siya

Important disclosures

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From 23rd March 2015 HSBC has assigned ratings on the following basis:

The target price is based on the analyst's assessment of the stock's actual current value, although we expect it to take six to 12 months for the market price to reflect this. When the target price is more than 20% above the current share price, the stock will be classified as a Buy; when it is between 5% and 20% above the current share price, the stock may be classified as a Buy or a Hold; when it is between 5% below and 5% above the current share price, the stock will be classified as a Hold; when it is between 5% and 20% below the current share price, the stock may be classified as a Hold or a Reduce; and when it is more than 20% below the current share price, the stock will be classified as a Reduce.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation or resumption of coverage, change in target price or estimates).

Upside/Downside is the percentage difference between the target price and the share price.

Prior to this date, HSBC's rating structure was applied on the following basis:

For each stock we set a required rate of return calculated from the cost of equity for that stock's domestic or, as appropriate, regional market established by our strategy team. The target price for a stock represented the value the analyst expected the stock to reach over our performance horizon. The performance horizon was 12 months. For a stock to be classified as Overweight, the potential return, which equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated, had to exceed the required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock was expected to underperform its required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile*). Stocks between these bands were classified as Neutral.

*A stock was classified as volatile if its historical volatility had exceeded 40%, if the stock had been listed for less than 12 months (unless it was in an industry or sector where volatility is low) or if the analyst expected significant volatility. However, stocks which we did not consider volatile may in fact also have behaved in such a way. Historical volatility was defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility had to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

Rating distribution for long-term investment opportunities

As of 10 October 2017, the distribution of all independent ratings published by HSBC is as follows:

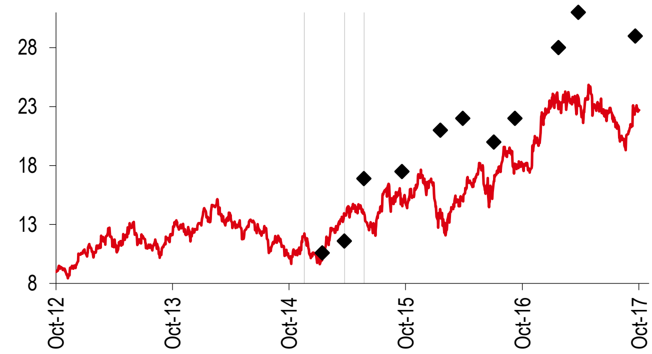
Buy	44%	(27% of these provided with Investment Banking Services)
Hold	42%	(25% of these provided with Investment Banking Services)
Sell	14%	(16% of these provided with Investment Banking Services)

For the purposes of the distribution above the following mapping structure is used during the transition from the previous to current rating models: under our previous model, Overweight = Buy, Neutral = Hold and Underweight = Sell; under our current model Buy = Buy, Hold = Hold and Reduce = Sell. For rating definitions under both models, please see "Stock ratings and basis for financial analysis" above.

For the distribution of non-independent ratings published by HSBC, please see the disclosure page available at http://www.hsbcnet.com/gbm/financial-regulation/investment-recommendations-disclosures.

Share price and rating changes for long-term investment opportunities

Buzzi Unicem (BZU.MI) share price performance EUR Vs HSBC rating history



Source: HSBC

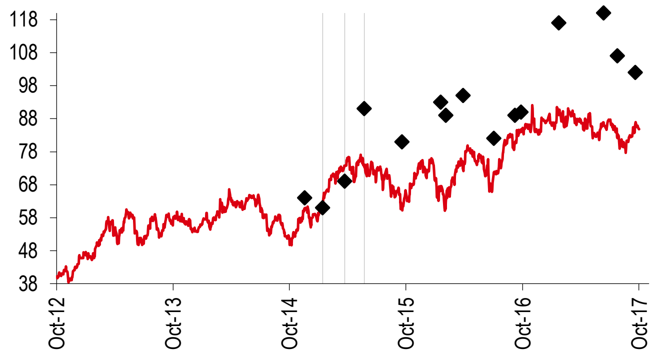
Rating & target price history

From	To	Date	Analyst
Overweight	Neutral	26 Nov 2014	John Fraser-Andrews
Neutral	Reduce	01 Apr 2015	John Fraser-Andrews
Reduce	Buy	01 Jun 2015	John Fraser-Andrews

Target price	Value	Date	Analyst
Price 1	10.60	22 Jan 2015	John Fraser-Andrews
Price 2	11.60	01 Apr 2015	John Fraser-Andrews
Price 3	16.90	01 Jun 2015	John Fraser-Andrews
Price 4	17.50	28 Sep 2015	John Fraser-Andrews
Price 5	21.00	27 Jan 2016	John Fraser-Andrews
Price 6	22.00	06 Apr 2016	John Fraser-Andrews
Price 7	20.00	12 Jul 2016	John Fraser-Andrews
Price 8	22.00	16 Sep 2016	John Fraser-Andrews
Price 9	28.00	31 Jan 2017	John Fraser-Andrews
Price 10	31.00	03 Apr 2017	John Fraser-Andrews
Price 11	29.00	28 Sep 2017	John Fraser-Andrews

Source: HSBC

Heidelberg Cement (HEIG.DE) share price performance EUR Vs HSBC rating history



Source: HSBC

Rating & target price history

From	To	Date	Analyst
Neutral	Underweight	22 Jan 2015	John Fraser-Andrews
Underweight	Hold	01 Apr 2015	John Fraser-Andrews
Hold	Buy	01 Jun 2015	John Fraser-Andrews

Target price	Value	Date	Analyst
Price 1	64.00	26 Nov 2014	John Fraser-Andrews
Price 2	61.00	22 Jan 2015	John Fraser-Andrews
Price 3	69.00	01 Apr 2015	John Fraser-Andrews
Price 4	91.00	01 Jun 2015	John Fraser-Andrews
Price 5	81.00	28 Sep 2015	John Fraser-Andrews
Price 6	93.00	27 Jan 2016	John Fraser-Andrews
Price 7	89.00	12 Feb 2016	John Fraser-Andrews
Price 8	95.00	06 Apr 2016	John Fraser-Andrews
Price 9	82.00	12 Jul 2016	John Fraser-Andrews
Price 10	89.00	16 Sep 2016	John Fraser-Andrews
Price 11	90.00	05 Oct 2016	John Fraser-Andrews
Price 12	117.00	31 Jan 2017	John Fraser-Andrews
Price 13	120.00	21 Jun 2017	John Fraser-Andrews
Price 14	107.00	03 Aug 2017	John Fraser-Andrews
Price 15	102.00	28 Sep 2017	John Fraser-Andrews

Source: HSBC

To view a list of all the independent fundamental ratings disseminated by HSBC during the preceding 12-month period, please use the following links to access the disclosure page:

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Clients of HSBC Private Banking: www.research.privatebank.hsbc.com/Disclosures

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price date	Disclosure
BUZZI UNICEM	BZU.MI	22.72	10 Oct 2017	4
HEIDELBERG CEMENT	HEIG.DE	84.83	10 Oct 2017	7

Source: HSBC

1 HSBC has managed or co-managed a public offering of securities for this company within the past 12 months.
2 HSBC expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months.
3 At the time of publication of this report, HSBC Securities (USA) Inc. is a Market Maker in securities issued by this company.
4 As of 30 September 2017 HSBC beneficially owned 1% or more of a class of common equity securities of this company.
5 As of 31 August 2017, this company was a client of HSBC or had during the preceding 12 month period been a client of and/or paid compensation to HSBC in respect of investment banking services.
6 As of 31 August 2017, this company was a client of HSBC or had during the preceding 12 month period been a client of and/or paid compensation to HSBC in respect of non-investment banking securities-related services.
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