S&P Global Ratings

Building Materials

Broadly stable credit quality in a softer business context

January 9, 2024

This report does not constitute a rating action.

What's changed?

The environment is gloomy in the residential building construction sector. Higher interest rates have impaired consumer demand and we do not anticipate volume recovery before 2025.

Industrial construction and civil engineering improved. Both benefit from investments in low-carbon energy, infrastructure renovations, and government spending.

Increased interest rates are a challenge for highly indebted companies. Higher debt service costs start to dent cash flows.

What are the key assumptions for 2024?

Credit quality will remain largely stable. This will be supported by decent rating headroom and balanced capital allocation. Still, there are pockets of weakness in the 'B' category.

Margins will stabilize as companies' ability to increase selling prices reduces. Still, we anticipate pricing discipline will persist, notwithstanding lower cost inflation.

Climate transition risk will continue to drive capital allocation. Despite weakened business confidence, most companies' capital expenditure (capex) remains unchanged or increases.

What are the key risks around the baseline?

More aggressive financial policies could lead to negative rating actions, particularly if shareholder remuneration remains high while volume decline continues.

Renewed geopolitical tensions or worsening local property crisis, such as in China, could undermine volume recovery in 2024. This could constrain companies with limited rating headroom.

Stricter carbon regulation could constrain high-emitting companies. Yet, large and more sophisticated companies could benefit from market consolidation.

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Ratings Trends: Building Materials

Chart 1
Ratings distribution

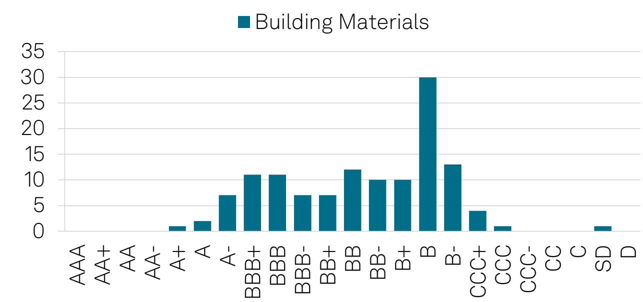


Chart 2
Ratings distribution by region

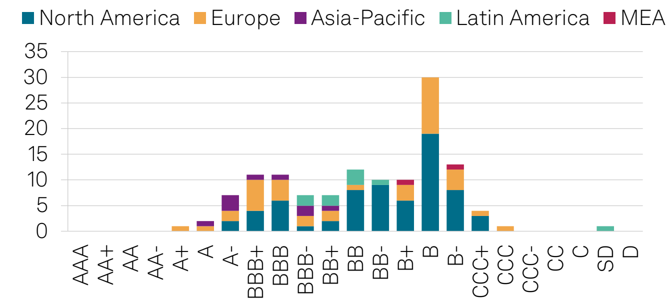


Chart 3
Ratings outlooks

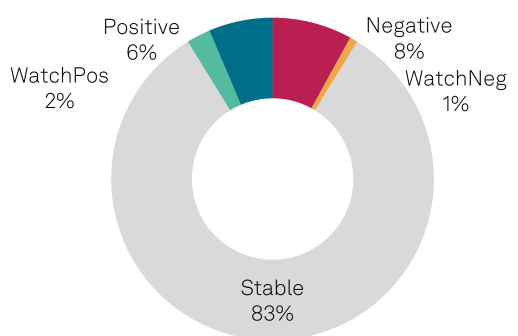


Chart 4
Ratings outlooks by region

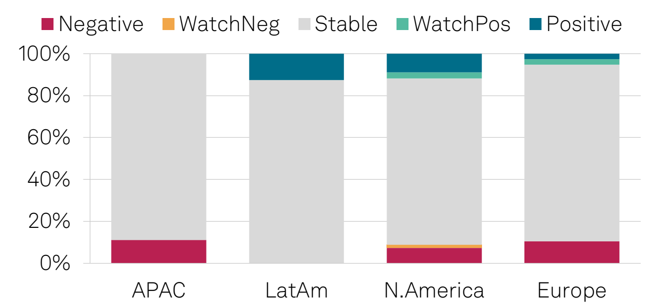


Chart 5
Ratings outlook net bias

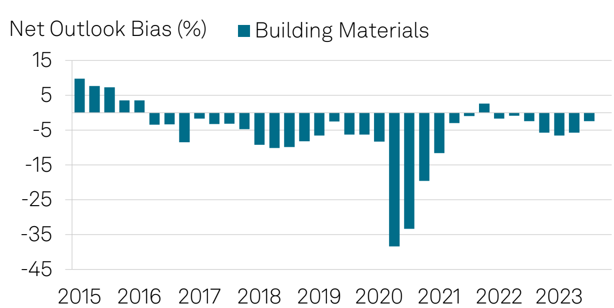
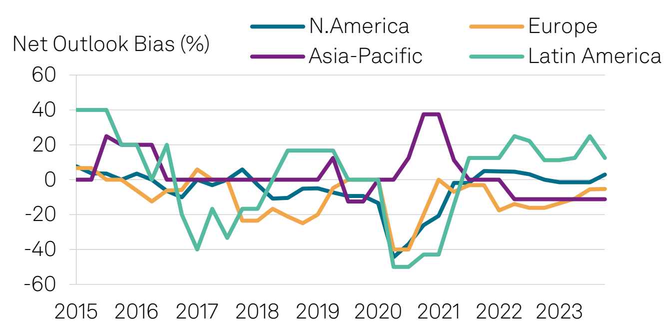


Chart 6
Ratings net outlook bias by region



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook: North America

Ratings trends and outlook

We expect conditions will remain broadly stable in 2024 as demand for nondiscretionary products, including roofing, persists, while considerable parts of the sector benefit from infrastructure-related spending. Even though the prolonged effects of inflation, weaker housing demand, and high interest rates impair discretionary product volumes, we expect North American building materials companies' credit quality will remain largely stable in 2024. The ratings on more than 85% of issuers have a stable outlook and the rating outlooks on the remaining companies are more or less split equally between negative and positive. We therefore anticipate that most issuers are well prepared to navigate continued macroeconomic normalization. Historically, any deterioration concentrated on low-rated, high-risk issuers.

The housing affordability index is at its lowest since 2006 due to rising borrowing costs and high inflation. Yet, we expect housing affordability to improve modestly, mortgage rates to decline slightly, and home prices to remain mostly flat through 2024.

Building materials companies still experience some margin pressure due to the slightly reduced ability to pass on higher costs to consumers as raw material and labor costs remain stubbornly low, albeit at lower levels, and competition for volumes remains high. On the other hand, companies reduce inventory and operating costs, which increases the likelihood of them meeting profit and leverage expectations in 2024.

Main assumptions about 2024 and beyond

1. Slowing demand for home repairs and construction could bite in 2024.

We expect continued revenue normalization in 2024 after a period of prolonged historically high earnings. The expectation that interest rates will remain high could prolong housing affordability challenges and continue to reduce consumer discretionary spending.

2. Margins will likely stay under pressure; however, strong public infrastructure spending should mitigate pressures for some issuers.

We expect margins will remain under pressure in 2024 because of high commodity, labor, and delivery costs. Aging housing stock and federal investments in infrastructure should increase demand but issuers will likely continue to rely on pricing power to maintain margins.

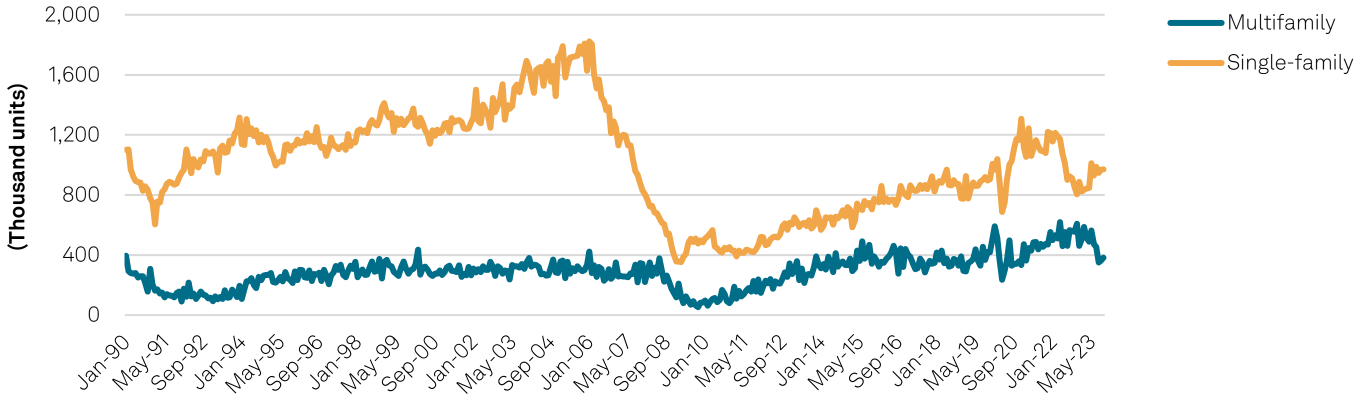
3. Financial policy is key to rating protection if demand were to dwindle.

If investment-grade companies increase shareholder remuneration, rating headroom could quicky disappear, especially considering increased interest rates. Speculative-grade companies with a low product diversity could experience downgrades after one-off dividend distributions or debt-financed acquisitions.

We expect repair- and remodel-exposed companies will be relatively less volatile than those exposed to construction. We expect revenue across the sector, especially in the case of commodity-based companies, will remain flat or decline by low single-digits in 2024. Low discretionary consumer spending levels could impair demand for some building products, such as kitchen cabinetry and bath fixtures. We expect housing starts will remain stable at about 1.4 million in 2024, after a decade-high in 2020 and another increase in 2021 (see chart 7). Since 2022, however, housing starts reduced to pre-pandemic levels because of rising interest rates.

Chart 7

U.S. housing starts

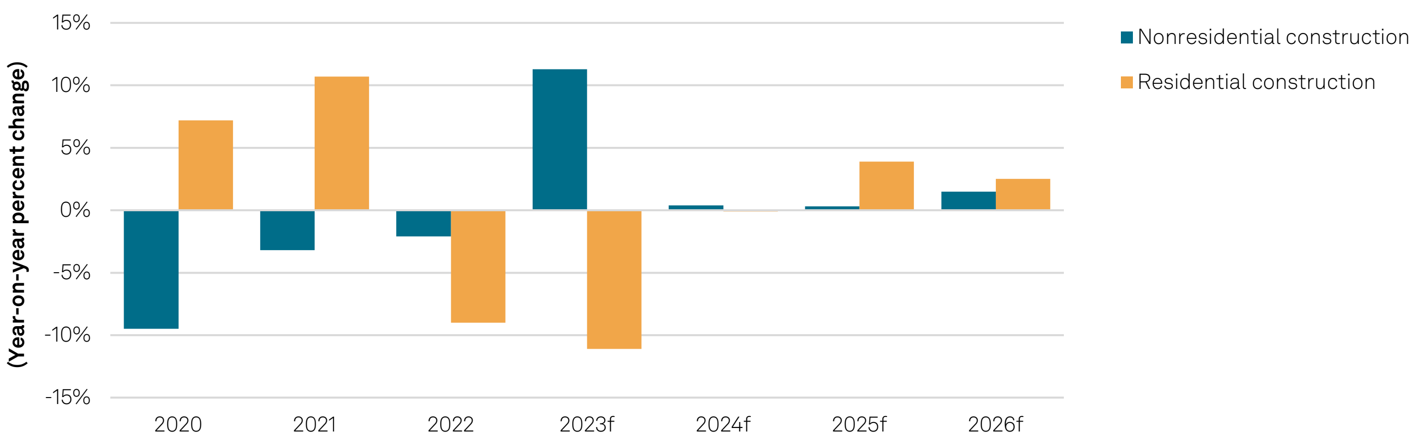


Note: Multifamily starts are housing starts of 5-unit structure. Data as of Oct. 2023. Source: Federal Reserve Economic Data.

Nonresidential construction will increase modestly in 2024, while residential construction will remain flat or decrease (see chart 8). We believe incentives, such as mortgage rate buydowns, help mitigate the negative effect of higher mortgage rates on housing demand and support residential sales. Similarly, the Biden administration's $1.2 trillion infrastructure bill will continue to support nonresidential investments, which will have a modest effect on the market in 2024. However, residential and nonresidential construction forecasts are notably bleaker because the sector still suffers from persistently high inflation and interest rates.

Chart 8

U.S. nonresidential and residential construction forecast



f—Forecast. Source: S&P Global Ratings Economics, Economic Outlook U.S. Q1 2024: Cooling Off But Not Breaking.

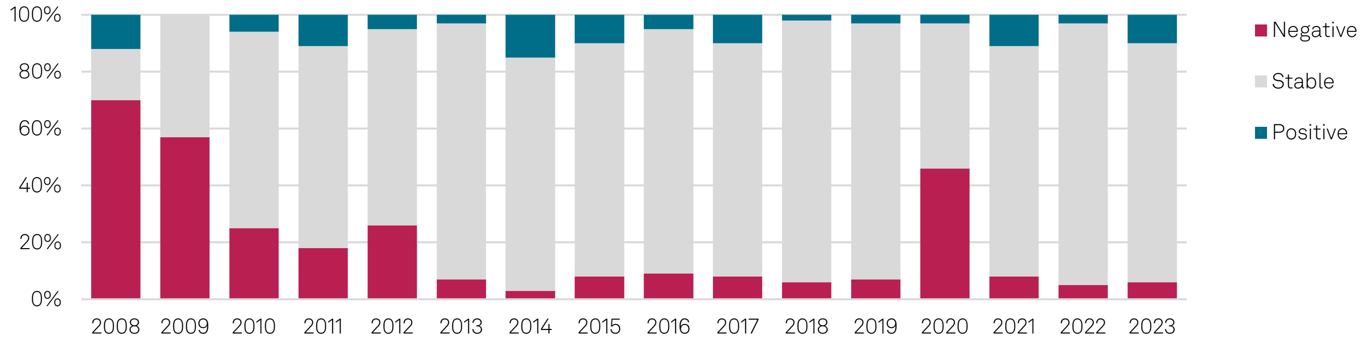
Credit metrics and financial policy

We anticipate an increase in competition will limit pricing power and, together with absorbing fixed costs, could lead to ongoing pressure on margins and earnings. However, tailwinds from nonresidential investments, repair and remodel spending, and new residential building activity will persist in 2024, albeit to a lesser extent than in recent years.

The outlook bias is slightly more positive than in 2022 (see chart 9). It reflects some issuers' ability to keep key credit metrics stable through the cycle and generally stronger credit metrics that resulted from strong financial results in recent years.

Chart 9

U.S. building material companies outlook distribution



Source: S&P Global Ratings.

Key risks or opportunities around the baseline

1. Interest rates and cost inflation could strain consumer spending and reduce earnings

Slowing demand for home repairs and construction amid persistent cost pressure would likely limit pricing power and put pressure on margins. Unfavorable price-cost mixes, sticky inflation in commodities, and high labor and delivery costs could result in weaker-than-expected earnings and cash flows.

2. High interest rates will increase refinancing risks for speculative-grade issuers

The debt of many speculative-grade issuers is priced at historically low interest rates. As the Fed increases its benchmark rates, we expect issuers will face an increase in their interest expenses and thus a reduction in their interest coverage metrics. On the plus side, most issuers do not have any significant debt maturities before 2025.

3. Slower growth in new construction and a sharper decline in remodel spending could lower revenue and earnings

While we believe home buyers adjust to higher mortgage rates and the demand for new homes is resilient so far, the full effect of higher-for-longer interest rates is still uncertain. A sharper-than-expected decline in the demand for homebuilding or renovation could put pressure on issuers that are more exposed to these segments.

Increased inflation is a risk to our base-case assumption. Most building material companies' margins already suffer from higher raw material prices. If higher interest rates and, with that, higher inflation persist, companies may find it more difficult to pass on costs to consumers. If they did, sales would most likely decrease and margins would drop below our base-case expectations. This could result in negative rating actions, especially for companies with significant exposure to discretionary consumer spending.

Aggressive financial policies remain among the main risks to ratings. Both private equity-owned and listed companies demonstrated aggressive debt-funded activities. While these activities took advantage of cheap debt, many did not deliver the expected credit benefits, resulting in lower credit ratings. Historically, the deterioration concentrated only on low-rated, high-risk issuers. Our downgrade of Stanley Black & Decker Inc. (A-/Negative/A-2) in August this year indicates that investment-grade issuers are also affected now. Expectations of lower growth and prolonged higher interest rates in 2024 increase the likelihood of more issuers turning to similarly aggressive financial policies, which could lead to credit deteriorations.

Industry Outlook: EMEA

Ratings trends and outlook

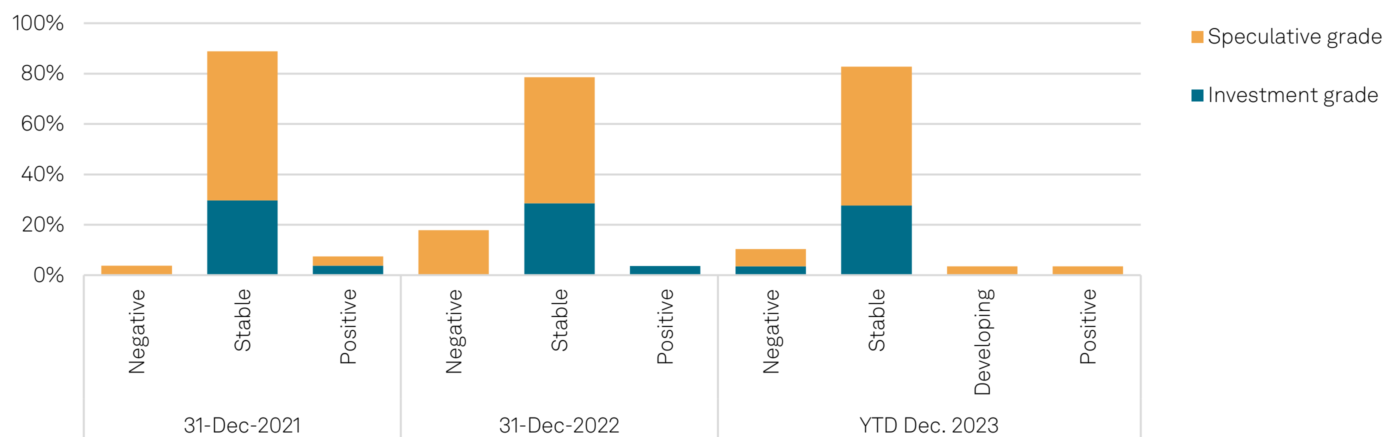
The European building materials sector suffers from a pronounced downturn in residential construction, particularly of new buildings, because increased mortgage rates and still-high construction costs reduced demand. We do not anticipate a rebound before 2025. At the same time, civil engineering remains solid on the back of large infrastructure fundings and projects.

EBITDA margins improved modestly in 2023, thanks to a positive price-cost gap, but companies' ability to increase selling prices will reduce significantly in 2024. The rating headroom that building materials companies built after the pandemic decreases. Still, about four-fifths of rated companies display a stable outlook (see chart 10). Negative outlooks reduced to 10% in December 2023, from 18% in December 2022. Even so, the negative outlook bias persists, indicating that negative rating actions should exceed positive ones in 2024.

We believe speculative-grade companies are more exposed to downgrades, given their weaker business diversity and limited financial flexibility. Rating headroom for investment-grade companies remains sound, with a few exceptions. We believe financial policies will continue to determine companies' creditworthiness and our ratings, both in the investment-grade and the speculative-grade category.

Chart 10

European building materials outlook distribution



YTD—Year to date. Source: S&P Global Ratings.

Main assumptions about 2024 and beyond

1. Volumes will continue to reduce or stagnate in most segments, apart from civil engineering.

According to Euroconstruct, the European construction outlook remains gloomy in 2024, especially in the Nordics, Italy, the U.K., and Germany. Growth should resume only in 2025. Most volume contraction is in new residential construction and residential renovation. Nonresidential building construction should stagnate until 2024. In contrast, volumes in civil engineering increase, thanks to investments in low-carbon energy and infrastructure renovation.

2. EBITDA margins will stabilize in 2024.

This follows a rebound in 2023, after the inflation-reduced drop in 2022. Raw material cost and energy disinflation over the past few quarters reduced companies' ability to increase selling prices, meaning companies may need to reduce their costs to offset lower volumes and protect their margins. Still, we anticipate pricing discipline will persist in the market.

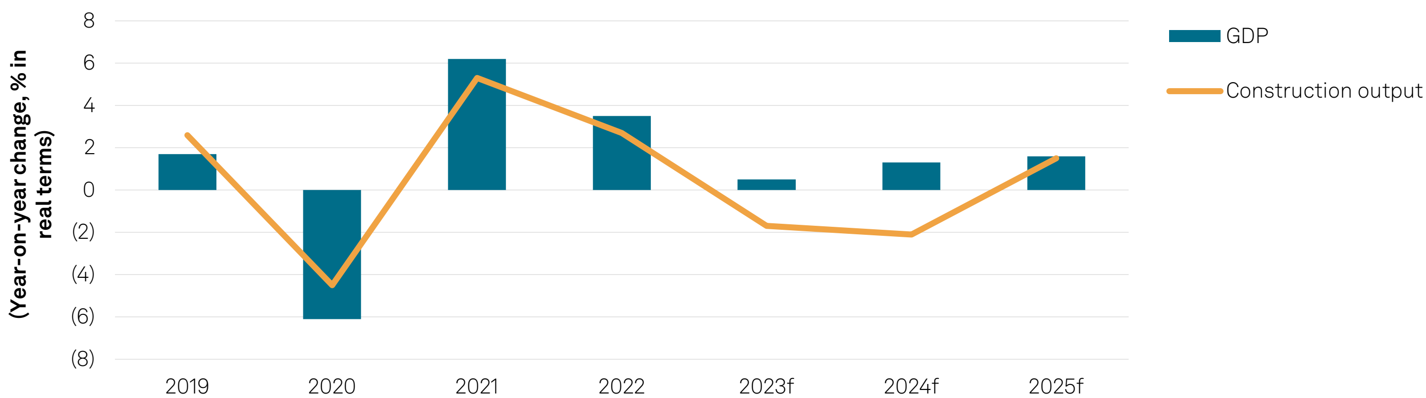
3. Capex plans remain broadly unchanged.

Despite weakened business confidence, most companies' capex remained unchanged or even increased in 2023. We anticipate an increase in capex of about 10% in 2023 and 5% in 2024. Most building materials companies prioritize investments in business segments with higher growth potential and less climate transition risk. Cement companies continue investments to meet their 2030 carbon reduction targets.

The economic and operating environment in the European construction sector remains gloomy in 2024. This largely reflects the sharp rise in interest rates and construction prices, persistently high inflation, households' reduced purchasing power, and falling property prices. Consumer spending continues to stagnate while business confidence remains weak, undermining any chance of a strong GDP rebound. According to Euroconstruct, construction output should contract by 2.1% in 2024, after a decrease of 1.7% in 2023, and rebound moderately in line with GDP growth over 2025-2026 (see chart 11).

Chart 11

GDP and construction output in Europe (EC -19, % change)



f—Forecast. Sources: Euroconstruct, S&P Global Ratings.

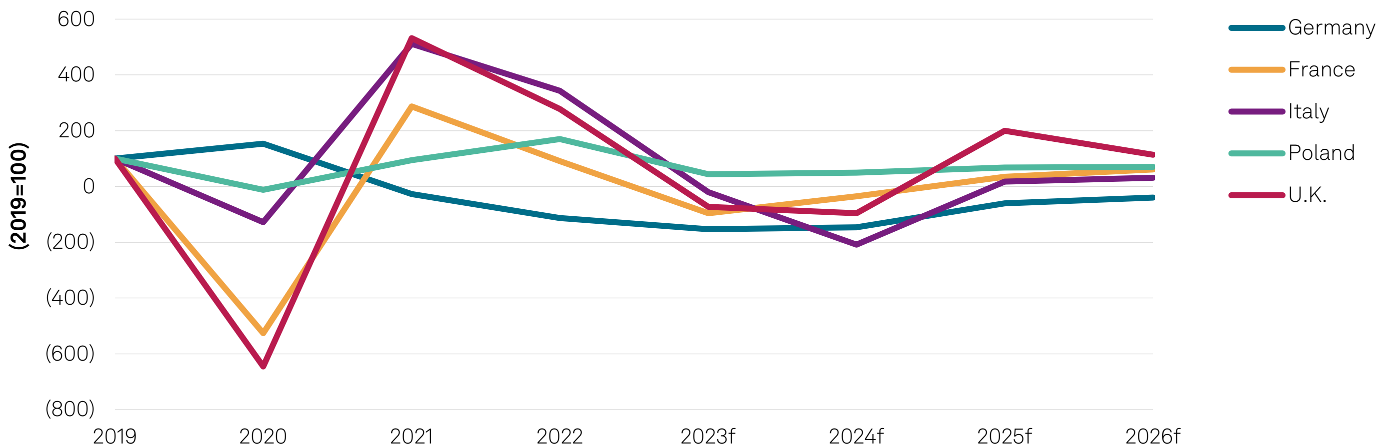
Most of the drop in contraction still relates to the new residential sector, where housing permits remain at a depressed level. The residential building renovation sector, which grew strongly over 2021-2022, will also experience a contraction over 2023-2024. According to Euroconstruct, the market volume of residential construction will reduce by 10% over 2023-2024. Nonresidential building construction should also stagnate until 2024. In particular, the commercial real estate segment suffers from the growing uncertainty about the future of hybrid work practices.

Civil engineering and industrial construction should continue benefiting from investments in low-carbon energy production, energy distribution, and transport networks. This follows the implementation of the NextGenerationEU strategy. Companies offering light products in heating, ventilation, air conditioning, and electricity (including cables and installation materials, lighting, automation, data, and safety products) should experience a lower drop in volumes than companies that offer heavy building materials.

Business conditions are more challenging in the Nordics, Italy, the U.K., and Germany. Volumes in the building materials sector should reduce further in 2024 and rebound modestly in 2025. Construction volumes should drop in most European countries in 2024, driven by the residential sector (see chart 12). We expect some recovery only in 2025. The contraction should be more pronounced in Italy and the Nordics, where the combined drop of the residential sector over 2023-2024 will exceed 20%. The residential sector in Italy performed best over in 2021-2022, with a cumulative growth of about 30%. This was because of generous tax incentives to the residential renovation segment during the pandemic. The current downturn reflects the reduction of these incentives, on top of increased interest rates and high construction costs. However, the residential sector should contract in most countries, including the U.K. (-11%), Germany (-7%), and France (-5%).

Chart 12

Construction output by country (EC -19, index, 2019=100)



f—Forecast. Sources: Euroconstruct, S&P Global Ratings.

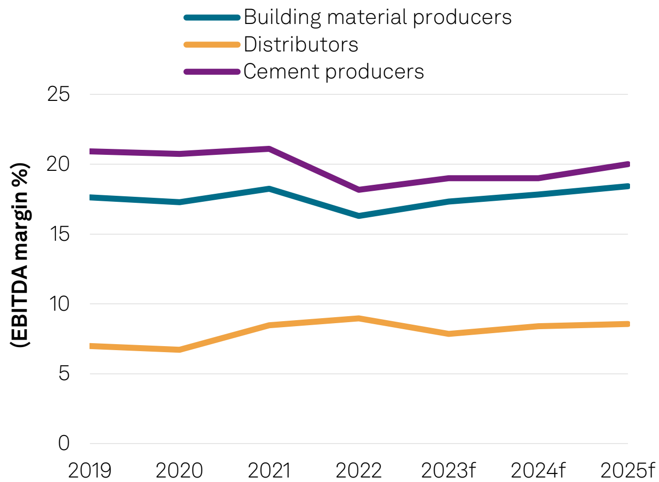
We expect EBITDA margins will be broadly stable in 2024 and improve modestly in 2025 (see chart 13). Margins remain below 2021 levels. Raw material cost and energy disinflation over the past few quarters reduced companies' ability to increase selling prices. As such, companies shift their attention to their cost base to increase efficiency and cost synergies, offset lower volumes, and protect margins.

We anticipate pricing discipline will persist in the market. Building material companies were able to pass on cost inflation to clients over 2022-2023, reflecting both supportive demand and strong pricing discipline. Absolute EBITDA has swiftly recovered from the pandemic and even expanded due to M&As, particularly in the case of private equity-owned distributors (see chart 14). We expect some volume rebound will improve margin modestly in 2025, largely due to better operating leverage.

Raw material cost and energy inflation has eased significantly in 2023 after a peak in 2022, reflecting a globally weakened demand. For example, spot prices on the Title Transfer Facility (TTF) of natural gas, a key energy source in some building materials segments, have dropped significantly since the third quarter of 2022 and averaged below €50 since the second quarter of 2023. Price volatility reduced significantly. Yet, natural gas prices remain about 2x higher than they were before the pandemic, while persisting geopolitical tensions could translate into renewed volatility in the winter season.

Chart 13

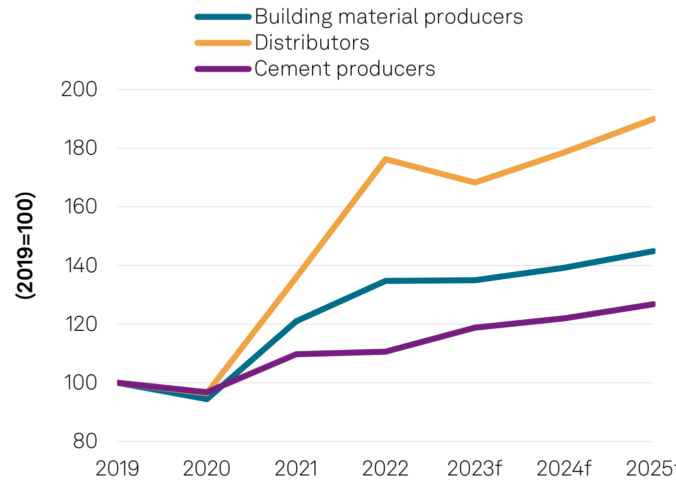
Adjusted EBITDA margin



f—Forecast. Source: S&P Global Ratings.

Chart 14

EBITDA trend (index 2019=100)



f—Forecast. Source: S&P Global Ratings.

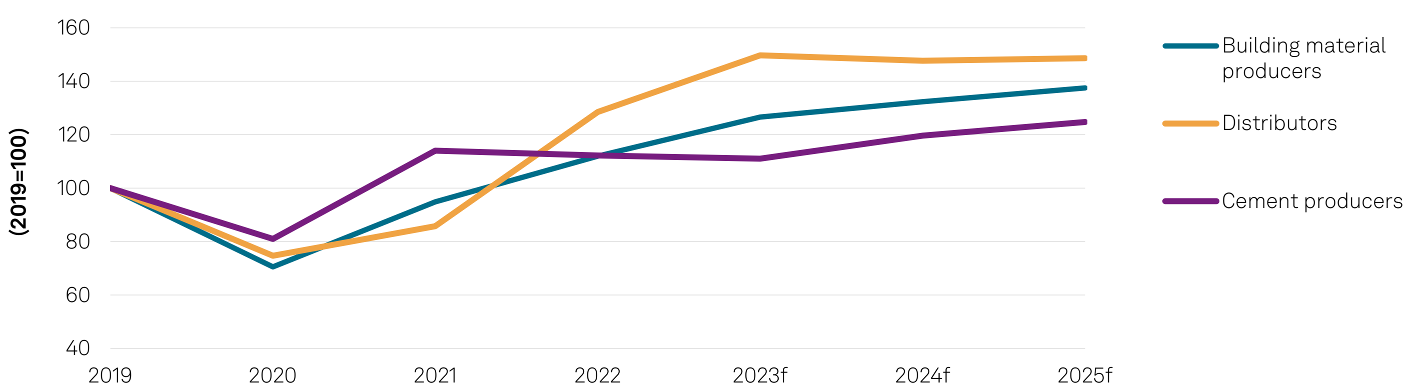
Among other relevant raw materials in the sector, copper, steel, and aluminum wholesale purchase prices have normalized, compared with the peak in 2022. Yet, they remain above pre-pandemic levels because of additional demand resulting from infrastructure renovations, energy efficiency renovations, and digitalization.

We estimate that building materials companies' energy bills, on average, modestly decreased in 2023, compared with 2022, when they increased an average of 50% from 2021 levels. Less hedged companies benefited more from lower spot energy prices in 2023, compared with 2022, and their profitability margins could benefit from a temporarily larger gap between selling prices and costs. However, most Europe-based building materials companies have significant operations outside the continent, where the pressure on energy bills is comparatively lower.

Despite weakened business confidence, most companies' capex remained unchanged or even increased. We anticipate an increase in capex of about 10% in 2023 and 5% in 2024 (see chart 15). Climate transition continues to drive capital allocation. This is the case for cement manufacturers, who invest to reduce their carbon footprint and meet their 2030 carbon reduction targets, and light-side companies that enlarge their product offering to meet the demand for energy efficiency improvements.

Chart 15

Capex evolution (index 2019=100)



f—Forecast. Source: S&P Global Ratings.

Climate transition risk is at the core of cement companies' capital allocation. Cement companies assign an increasing share of their maintenance capex to improve plants' thermal efficiency and cut carbon dioxide (CO2) emissions. Investments relate to increasing the use of alternative fuels or biomass, decreasing clinker content, and accelerating process innovation.

We estimate investments associated with reaching 2030 CO2 reduction targets account for a large part of European cement companies' yearly maintenance capex. Some companies switch to other building products, which helps reduce their consolidated carbon intensity. The most tangible example is Holcim, whose growth strategy focuses on increasing its share of value-added products and strengthening its environmental credentials by moving away from the core cement business.

Credit metrics and financial policy

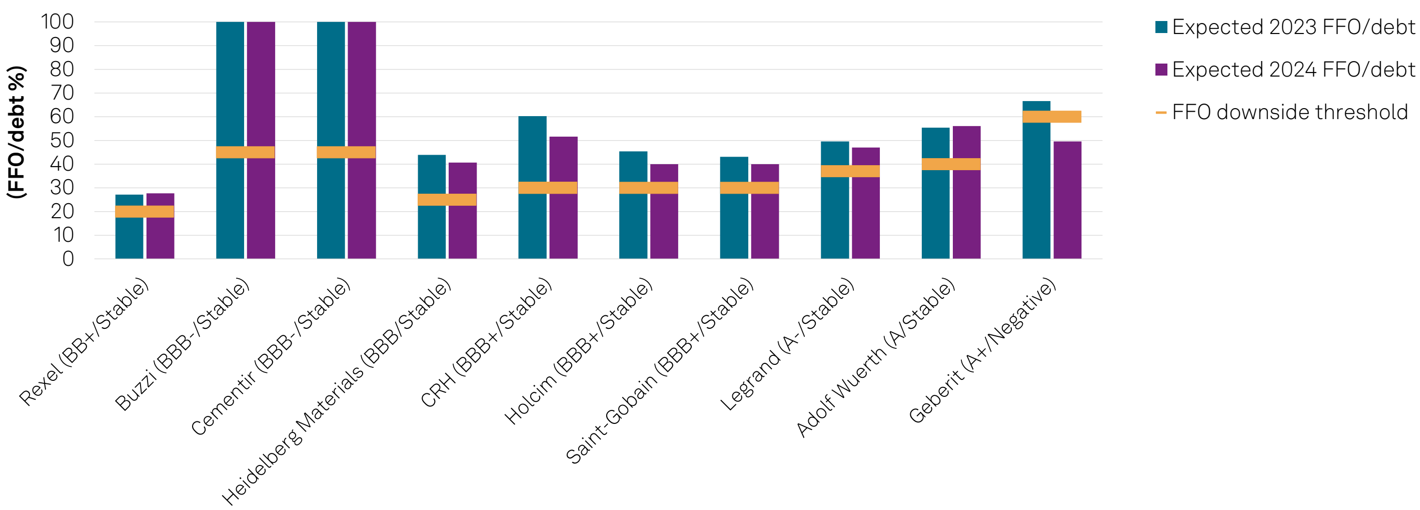
The building materials sector recovered swiftly from the COVID-19 pandemic, benefiting from very strong end-market demand. It started 2023 with, on average, solid rating headroom, with a few exceptions in the speculative-grade category. The drop in volumes in residential real estate construction in 2023 did not translate into a significant weakening of credit metrics for companies that are also active in commercial real estate and civil engineering. This is because these companies could still leverage price increases, while their operating cash flows benefited from reduced cash absorption related to working capital.

Most companies in the investment-grade category benefited from price increases and solid cash flow. In April 2023, for example, we raised our rating on Saint-Gobain to 'BBB+' from 'BBB' to reflect the company's continued solid performance, which enabled it to absorb sustained heavy spending and investments while maintaining strong credit metrics.

Currently, most investment-grade issuers' rating headroom remains unchanged or has reduced modestly (see chart 16). One notable exception is Geberit AG (A+/Negative/A-1), for which we revised the outlook on the long-term rating to negative from stable in November 2023. The outlook revision reflects that the company continues its generous shareholder returns despite a soft environment in the sanitary market. We forecast that median S&P Global Ratings-adjusted leverage of investment-grade issuers will increase modestly to 1.6x in 2024, from 1.4x in 2023.

Chart 16

Rating headroom of main rated investment-grade issuers



Note: FFO-to-debt of Buzzi and Cementir is expected to be above 100%. Source: S&P Global Ratings.

Investment-grade companies' shareholder remuneration remains generous. Share buybacks increased further in 2023, leading to record shareholder remuneration. We expect shareholder remuneration will decrease slightly in 2024, largely due to less share buybacks. We anticipate that investment-grade companies with solid rating headroom will continue pursuing M&As.

Most sponsors in the speculative-grade category have taken a conservative approach since early 2023 to protect companies' credit metrics. We have not seen any announcements of shareholder remuneration or large new acquisitions. That said, speculative-grade issuers' credit metrics deterioration has been more pronounced than investment-grade issuers', largely due to the former's lower business and geographical diversification, particularly in the 'B' category.

We lowered some ratings, largely on the few companies that entered the business downturn with limited rating headroom and that suffered from lower business volume and cash flow generation. Yet, we also upgraded some companies in the 'BB' category to reflect resilient operating performance in some business segments, such as electrical distribution.

We understand most private equity-owned companies will focus on deleveraging in 2024. We therefore believe an increase in financial leverage because of acquisitions or shareholder remuneration will be unlikely over next few quarters, unless business recovery is tangible. We forecast that median adjusted leverage of speculative-grade issuers will remain at about 6x in 2024. We also anticipate that median free operating cash flow (FOCF) will modestly improve in 2024, versus 2023, due to lower working capital cash flow absorption and despite higher interest costs. Yet, FOCF will remain below 2019 levels.

Sector regulation update

Several key regulations to cut carbon emission came into force in the EU in 2023. We anticipate this momentum will continue in the coming years.

In March 2023, the European Union Council adopted key pieces of legislation on 2030 climate targets. The legislation will enable the EU to cut greenhouse gas emissions within the main sectors of the economy, while making sure the most vulnerable citizens, micro-enterprises, and sectors exposed to carbon leakage are well equipped to navigate the climate transition. The laws are part of the "Fit for 55" program, which aligns the EU's policies with its commitment to reduce net greenhouse gas emissions by at least 55% by 2030 compared with 1990 levels, and to achieve climate neutrality by 2050. The new pieces of legislation that are most relevant for the building material sector include:

- EU Emissions Trading System (EU ETS): A carbon market based on a system of cap-and-trade of emission allowances for energy-intensive industries, including cement, power generation, and aviation. The new rules increase the overall ambition of emission reductions by 2030 in the sectors covered by the EU ETS to 62%, compared with 2005 levels.
- Carbon Border Adjustment Mechanism (CBAM) concerns product imports in carbon-intensive industries, such as cement. The objective of CBAM is to ensure--while fully complying with international trade rules--that the EU's greenhouse gas emission reduction efforts are not offset by an increase in emissions outside the EU. This could result from the relocation of production to countries where climate change policies are less ambitious than those in the EU or an increase in imports of carbon-intensive products. The CBAM will apply only as a reporting obligation until the end of 2025. CBAM will be introduced gradually, while free allowances for sectors covered by the CBAM, including cement, aluminum, iron, and steel, will be phased out over 2026-2034. CBAM promotes the import of goods by non-EU businesses, which fulfil the high climate standards applicable in the 27 EU member states, into the EU. This will ensure a balanced treatment of such imports and encourage others to join the EU's climate efforts.

RePowerEU is a key framework to finance energy renovation, including carbon capture, usage, and storage (CCUS) technologies. The adoption of the EU Green Deal, the Climate Law, and the subsequent proposals to increase energy and climate targets for 2030 made carbon capture and storage technologies an important part of the EU decarbonization effort in hard-to-abate sectors, such as cement.

In 2023 there was a recast of the Energy Performance of Building Directive, aiming to accelerate building renovation rates, reduce carbon emissions and energy consumption, and promote the uptake of renewable energy in buildings. It would introduce a new EU definition of a "zero emissions building," applicable to all new buildings from 2027 and to all renovated buildings from 2030. The directive would provide a significant boost to companies whose products target building energy efficiency, such as insulation.

Key risks or opportunities around the baseline

1. Further reduction in demand and inability to keep prices would impair credit metrics.

Revenue and profitability could reduce further if construction cost inflation does not ease and housing materials become too expensive, leading to lower demand, which could spread to commercial end-markets. We understand that building materials producers are not willing to decrease prices and profitability, which would lead to lower volumes sold.

2. The building materials sector is benefiting from long-term megatrends.

The sector faces several megatrends, such as decarbonization, digitalization, a boom in infrastructure investments, and aging housing stocks. We see decarbonization primarily as a risk for ratings in the sector, while the other megatrends could be opportunities. We believe investment-grade companies, which display solid business diversification and higher capex capacity, are more likely to benefit from these trends.

3. More aggressive financial policies could lead to negative rating actions.

Rating pressure may arise if shareholder remuneration remains high, especially in a context of weak demand and declining volumes. Debt-funded acquisitions may also constrain credit metrics. Private equity-owned issuers remain exposed to dividend recapitalization and highly leveraged capital structures with rising interest expenses.

Demand contraction tests issuers' pricing power and cost flexibility. Demand from end-markets started to decline in 2022. Some issuers retained a good level of activity but that was partly due to their existing backlog. However, activity in the residential building end-market in Europe has materially contracted in 2023, on the back of rising interest rates and rising building materials product prices. We do not expect a recovery before 2025.

It will take some time before companies rebuild their order books, new building projects resume, and financial results recover. So far, commercial end-markets have been relatively resilient. However, recession risks could threaten retail and hospitality. Should the market decline be more prolonged and noticeable than we expect, profitability margins, free cash flows, and financial leverage could weaken.

Companies may struggle to implement additional price initiatives and maintain their profitability in 2024. This stands in stark contrast to 2022, when issuers could pass on raw materials inflation. In 2023 some companies started to reduce selling prices, and some also mothballed or permanently closed parts of manufacturing facilities. Therefore, the ability to adapt the cost base to the current downturn will be key for issuers. And we expect companies will continue facing wage inflation.

Several issuers are well positioned to benefit from long-term megatrends. We have identified several megatrends that will likely benefit the building materials sector in the medium to long term:

- Several infrastructure plans will boost activity over the coming years, both in the U.S. and in Europe. In 2021 the U.S. Senate approved the $1.2 trillion infrastructure package, which includes $550 billion in new investments in roads, bridges, power grids, water infrastructure, and broadband, among others. In Europe, NextGenerationEU also contains investments in infrastructure. Many important projects are already ongoing, such as Grand Paris in France and HS2 in the U.K. The onshoring of key industries, such as semiconductors, will also support the demand for building materials. We expect higher revenue growth for issuers exposed to the infrastructure market, such as cement producers and some general building materials manufacturers.
- We also see opportunities from aging housing stocks and renovation needs to meet sustainability targets in the U.S. and Europe. The latter will come with more energy-efficient products, such as insulation panels, heat pumps, and new windows. Regional and European plans, such as the European energy efficiency directive and the French national recovery plan, will support the transition. Companies such as Saint-Gobain, which provide energy efficient products, are well positioned to benefit from the trend.
- Building materials companies must prepare for an increasing use of digital tools and services for customers and in-house processes. Digitalization can help reduce delays, improve know-your-customer initiatives, and increase efficiency and profitability. We believe connected products and the internet of things will be growth areas in the coming years. Companies, such as Legrand, that offer connected products, could show higher growth in this segment. In contrast, smaller companies that cannot invest in digitalization will likely lose some competitive advantages.

On the other hand, we see decarbonization primarily as a risk for ratings. The building materials sector, particularly cement companies, accounts for about 8% of global CO_2 emissions. Building materials producers face cost pressures because the EU’s "Fit for 55" program will increase carbon costs significantly.

Annual carbon costs could account for, on average, 75% of EU cement companies' EBITDA, assuming a complete phase-out of allowances. Yet, cement substitution alternatives are limited and demand should remain steady. We monitor cement companies’ ability to pass on higher carbon costs and note that issuers that invest less in carbon reduction innovation may suffer more.

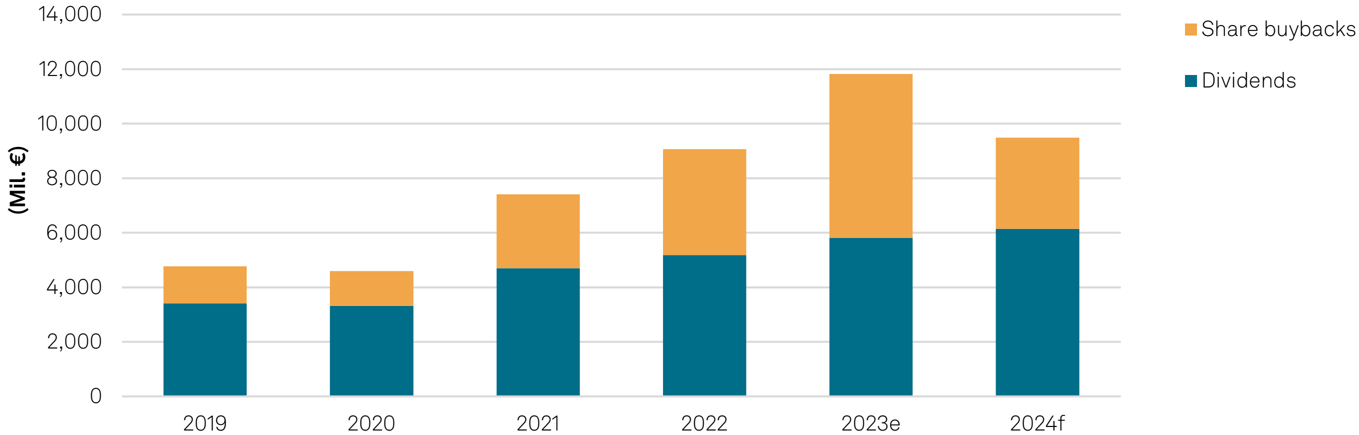
Shareholder-friendly financial policies could consume rating headroom and lead to a greater deterioration of credit metrics than we anticipate. Shareholder remuneration has significantly increased in recent years, on the back of solid results. While dividends of building materials issuers in the investment-grade category have increased by an annual average of about 12% since 2019, share buybacks more than tripled over the same period (see chart 17).

Aggregated share buybacks will reduce in 2024 as revenue and profitability normalize. In addition, some issuers should have completed their share buyback programs by the end of 2023 and in 2024. However, if issuers do not scale down shareholder remunerations, they could face tighter rating headroom. For example, we recently revised the outlook on the rating on Geberit AG to negative from stable as the company continues its generous shareholder remuneration.

Rating pressure could also stem from debt-funded M&As, which usually weaken companies’ financial leverage. Private equity-owned issuers remain exposed to dividend recapitalization, while their capital structures are already highly leveraged. This is relevant in the context of rising interest expenses, which dent FOCF. Our base-case scenario does not factor in dividends or transformational M&As for private equity-owned companies because their size and timing are generally uncertain.

Chart 17

Largest European building materials companies' shareholder remuneration



e—Estimate. f—Forecast. Companies include Buzzi Unicem, Compagnie de Saint-Gobain, CRH, Geberit, Heidelberg Materials, Holcim, Legrand, Rexel, and Wuerth. Source: S&P Global Ratings.

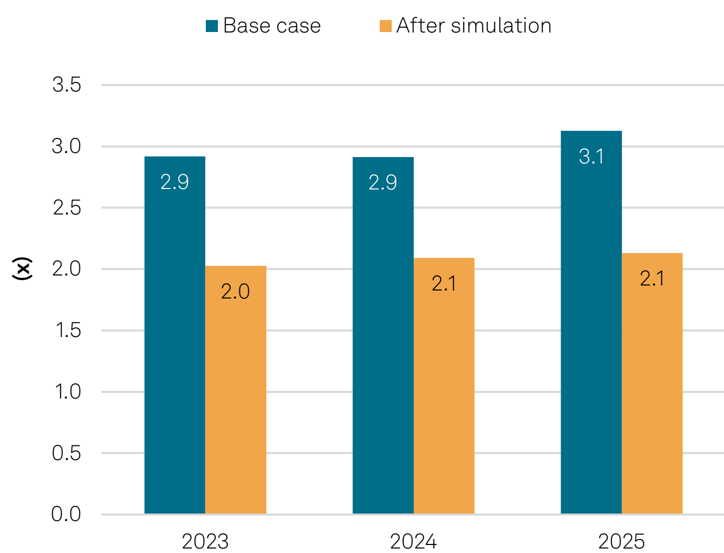
High interest rates impair the FOCF of European private-equity owned issuers, given these companies' weaker business profiles, highly leveraged capital structure, and weaker liquidity profile, compared with investment-grade companies. Since July 2022, the European Central Bank (ECB) increased interest rates 10 times, while the deposit rate increased to 4.0%, from negative 0.5%. As a result, borrowing costs for corporates rose materially. However, many speculative-grade companies have either fixed notes or debt hedges and suffer not yet from the negative effects of rising interest rates on credit metrics.

We applied a stress test to the 18 rated issuers in the 'B' and 'CCC' categories. The stress test assumes an immediate pricing of the existing debt capital structure at an interest rate of 9.5% for issuers in the 'B' category and 10% for issuers in the 'CCC' category. It does not assume any interest rate hedging. We found that the median EBITDA interest coverage would fall to 2.0x over 2023-2024, from 3.0x in our current base-case scenario (see chart 18).

Companies have comfortable headroom under their EBITDA interest coverage ratios in a low-rate environment, but this could change in light of high interest rates. We estimate that about 40% of issuers of the stress test sample could display either negative FOCF or interest coverage below 2.0x, which could put pressure on the ratings (see chart 19). Therefore, we believe the rise in interest rates will structurally damage speculative-grade issuers' free cash flows, which will not return to 2019-2021 levels. We will monitor companies that may report consistently negative free cash flows.

Chart 18

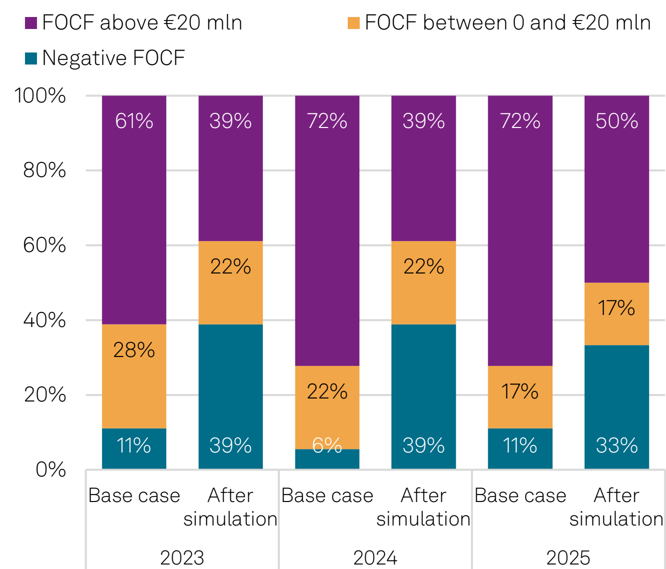
Median EBITDA interest coverage after stress test



Source: S&P Global Ratings.

Chart 19

Share of issuers with negative FOCF



Source: S&P Global Ratings.

About 20% of rated issuers in the 'B' and 'CCC' categories have fixed-rate debt instruments, with no imminent refinancing needs. This leads to stable interest expenses. In addition, most of the issuers with floating-rate debt instruments implemented either partial or full debt hedges, which also limit the increase in interest expenses. European speculative-grade issuers have limited refinancing needs before 2026. However, we expect interest rates (and therefore interest expenses) will be significantly higher when companies will refinance their debt. This will weaken their free cash flows if they do not reduce their debt amounts.

Industry Outlook: Latin America

Ratings trends and outlook

We expect credit quality for Latin America building materials companies will remain broadly stable through 2024 because close to 75% of rated entities have a stable outlook, while the remaining outlooks are positive. 22% of our rated issuers are currently investment grade and 78% are speculative grade, most of them in the 'BB' category.

Revenue growth will decelerate to close to 6% in 2024, compared with an expected 10% in 2023. This is because we now anticipate less pronounced price increases to ensure steady volume growth. We expect some recovery in residential investments and an uptick in nonresidential investments in Brazil and Mexico, the two largest economies in Latin America.

EBITDA margins will stabilize or modestly increase in 2024, driven by easing energy prices, inflation-induced price increase, and operating efficiencies. This, coupled with our expectation of continuously prudent financial policies, will lead to a slight improvement in credit metrics. Yet, several downside risks could affect our expectations for growth and operating margins:

- Economic and political risks remain high in Latin America and could weaken investor sentiments, reduce consumer spendings, squeeze companies' capacity to pass on costs increases, and undermine operating and financial performance beyond our current estimate if they materialize. In our view, policy predictability and investments in critical infrastructure will be key.
- External factors, such as geopolitical risks, are currently contained but could increase energy price volatility and impair operating margins and credit metrics. Nonetheless, we believe most of our rated issuers have some degree of financial flexibility in terms of leverage and liquidity buffers to withstand adverse business conditions and higher investments in capex and M&As without damaging their credit profile.

Proactive decarbonization strategies are an opportunity to prevent longer-term operating and financial risks. So far, CO2 regulations in Latin America are limited.

Most of the rated building materials issuers in Latin America generally maintain extended debt maturity profiles, with no refinancing risk in 2024. However, speculative-grade issuers remain more vulnerable to longer periods of high interest rates, refinancing risks, and sticky inflation.

Main assumptions about 2024 and beyond

1. Softer economic activity and prices will decelerate revenue growth in 2024.

We forecast Latin American building materials companies' revenue will increase by 6% in 2024, from an expected 10% in 2023. The increase will vary by country and benefit from a mix of volumes due to an uptick in public nonresidential investments, a still-high level of remittances for informal construction activities, and softer price increase versus 2023.

2. Easing input costs will stabilize operating margins.

Deflating energy costs, price adjustments in line with inflation, and operating efficiencies should stabilize or, in some cases, slightly improve operating margins, following a partial recovery in 2023, after a shortfall in 2022.

3. Credit metrics will improve modestly, supported by prudent financial policies.

Prudent financial policies and strong operating performance will lead to a modest improvement in Latin American building materials companies' key credit metrics in 2024. Some entities maintain strong liquidity positions and leverage leeway to increase investments and shareholder remunerations without damaging their credit profile.

Our updated forecast for 2024 suggests softer growth prospects for Latin American building materials companies, although business conditions will continue to vary across countries. For 2024, we expect real GDP growth of 1.2% for the region, although this will vary across countries.

- **The Brazilian economy will expand by 1.5% in 2024,** versus 1.2% previously projected, driven by continued--albeit diminishing--fiscal support. We think business conditions for building materials companies will be more supportive in 2024, thanks to higher-than-expected GDP growth and lower interest and inflation rate expectations, which should bolster a recovery in residential investments, as well as public and private nonresidential investments, especially toward the second half of 2024.
- **The Mexican economy will expand by 1.8% in 2024,** after a surprisingly strong 2023, in line with U.S. GDP growth expectations. In our view, Mexico's building materials sector will continue to benefit from robust remittances that support informal housing and home improvements and from the recent sharp uptick in public nonresidential investments. Yet, we lowered our GDP growth estimates for 2024 for other Latin American countries, such as Argentina, Peru, Colombia, and Chile.
- **GDP in Argentina will contract for the second year in a row in 2024.** This suggests difficult business conditions for building materials companies, at least during the first half of 2024 as the outlook is highly uncertain due to the fiscal and exchange rate adjustments that are likely under the next administration.
- **The Peruvian economy will grow just above 2% in 2024,** after relatively flat growth in 2023. We expect demand for cement will grow in line with economic activity, after the normalization in 2023 and all-time highs over 2021-2022.
- **Fixed investments in Colombia continue to contract.** Uncertainty over policies under the current administration will likely subdue investments through most of 2024.
- **We lowered our 2024 growth outlook for Chile by 10 basis points (bps) to 1.9%.** Uncertainties about the new constitution continue to weigh on investor confidence.

Easing input costs will gradually stabilize operating margins, with only some room for further improvements. Following a reduction in EBITDA margins by an average of 210 bps in 2022 induced by input cost inflation, particularly for energy, electricity, and transportation costs, we expect building materials companies will stabilize their operating margins in 2024. This follows a solid partial recovery in 2023, thanks to companies' ability to pass on prices and a resilient demand.

Companies partially regained operating margins in 2023, thanks to significant local currency pricing increments that outpaced easing input costs. We believe building materials companies will pursue more cautious pricing strategies in 2024 to ensure volume growth. Thus, we predict that average EBITDA margins in the sector should stabilize by the end of 2024.

Credit metrics and financial policy

In recent years, Latin American building materials companies prioritized excess cash to reduce their net debt positions over large investments and shareholder remunerations. This enabled them to gradually deleverage their balance sheets, with average adjusted debt to EBITDA of 2.0x-3.0x.

We expect Latin American building materials companies will deliver steady operating performance and sustain their disciplined capital allocation strategies in 2024. Capital allocation strategies will be balanced between growth--through capex and potential acquisitions--with short-term paybacks and debt reductions. The latter will support deleveraging strategies, with adjusted debt to EBITDA inching toward 2x.

Rated companies with leverage leeway and solid cash reserves might increase capex and M&As, particularly in the U.S., to expand and diversify their operations. Even though some entities might slightly increase or resume dividend payments over the next few years, we do not expect a significant shift in financial policies. Finally, Latin American building materials companies' debt maturity profiles bear limited short-term refinancing risks.

Key risks or opportunities around the baseline

1. Economic and political challenges pose downside risks to our growth baseline.

We constantly monitor economic and political risks as they could impair investor sentiment, reduce consumer spending, squeeze companies' capacity to pass on cost increases, and undermine operating and financial performance beyond our current estimate.

2. Geopolitical tensions and adverse weather conditions could undermine our forecast.

Geopolitical events could increase energy price volatility, which, in turn, would undermine operating margin stabilization, cash flows, and credit metrics beyond our current estimate. More-extreme weather conditions could also disrupt construction activities, as seen in Brazil, Mexico, and Peru in 2023.

3. Proactive decarbonization investments can reduce operating and financial risks.

Carbon tax regulation is progressing slowly in Latin America but investments in the reduction of CO_2 emissions remain a priority for many issuers in the region. Several issuers have CO_2 reduction targets for 2030, which will require higher capex in 2024 and beyond.

Economic and political risks prevail in Latin America. These pose downside risks to our growth baseline for 2024. In our view, economic risks in the form of lower GDP growth, higher-than-expected inflation, and a prolonged period of tight financing conditions could impair investor sentiment, consumption trends, and companies' capacity to pass on cost increases. In the absence of sufficient countermeasures, these risks could, ultimately, reduce Latin American building material companies' operating and financial performance beyond our current estimates.

The risk of the U.S. economy facing a deep recession instead of a soft landing, which we currently expect, remains elevated. A recession would have significant negative implications for the global economy, particularly for Latin American countries that share strong economic ties with the U.S. On the other hand, a stronger-than-expected U.S. economy would be positive for Latin America but could increase interest rates, strengthen the U.S. dollar over the short term--which could increase inflation because of foreign exchange pass-through effects--and impair building materials companies' cash flows and credit protection measures. Finally, potential political instability after elections in 2023 and 2024 could undermine investment and impair growth prospects of the overall sector.

Geopolitical tensions and adverse weather conditions could undermine our growth forecast, prevent a stabilization in operating margins, and impair credit protection measures. The Israel-Hamas war increases already-elevated geopolitical risks and could reduce investments in emerging markets, such as Latin America. Moreover, energy prices could increase if the war intensifies and spreads across oil-producing countries in the Middle East.

Geopolitical events are major risks to our growth outlook for Latin American countries. They could hamper a continuous stabilization in operating margins, cash flows, and credit protection measures. In addition, unexpected severe weather conditions, as seen in Brazil, Mexico, and Peru in 2023, for instance, also pose latent downside risks to our forecast.

CO2 regulations remain limited in Latin America, but proactive decarbonization strategies could enable companies to prevent longer-term operating and financial risks. While the EU's "Fit for 55" program paves the way for a significant increase of carbon costs, CO2 regulations in Latin America remain limited at this stage. This may change, although the timing is uncertain for most countries in the region.

Many cement manufacturers in Latin America are proactively reducing their CO2 emissions. Among other things, they've expanded the use of biomass, optimized thermal efficiency at cement kilns, used low-temperature clinkers, increased the use of decarbonated raw materials in clinker, reduced the clinker factor in blended cement, and boosted clean electricity consumption. We consider budgeted investments for 2024 are manageable and will not deteriorate key credit metrics. Instead, these investment initiatives could become a crucial competitive advantage. Smaller players that make relatively slow progress in reducing emissions could suffer, particularly if regulations are enforced and become stricter.

Industry Outlook: Asia-Pacific

Ratings trends and outlook

The outlook on the ratings on all our rated building materials companies in Asia-Pacific (APAC) is stable. Our rated companies' leading competitive position in their respective countries and sufficient financial headroom should help them manage industry headwinds and keep their creditworthiness steady.

All ratings on the building materials companies in APAC remained unchanged in 2023, despite challenging operating conditions. This primarily indicates sufficient financial buffer and prudent financial discipline to offset demand uncertainty and profitability pressure.

Considering the slow recovery of China's property market, Chinese producers will likely endure another tough year. Demand for building materials will remain subdued after a sluggish 2023. Demand for building materials in South Korea will remain under pressure due to the weak domestic construction market. Despite volatile macro dynamics, the building materials industry in Australia continues to demonstrate resilience. We continue to see solid underlying demand for building products and good pipeline visibility.

Main assumptions about 2024 and beyond

1. Continuously high policy rate outside China impairs housing activity.

Given the pressure from higher-for-longer interest rates in the U.S., we expect no meaningful reductions in policy rates over the next six months. Yet, with core inflation continuing to ease, APAC's central banks are unlikely to tighten monetary policy again. Still high interest rates will continue to weigh on housing activity and therefore hamper demand for building materials.

2. Demand for building materials suffers from the slow recovery of the Chinese property sector.

A meaningful increase in demand in China will be unlikely in 2024 as the recovery of the Chinese property sector is slow and sequential. We expect weak demand and excess supply in lower-tier cities will cause an extended L-shaped recovery in property sales. Our base case assumes that sales in 2024 will decline by 5%, after a 10%-15% decline in 2023.

3. Rated companies will maintain prudent financial policies.

Despite their sufficient rating buffer, we expect our rated entities will maintain a disciplined investment appetite due to macro uncertainty. They are usually the industry leaders, with stronger balance sheets and minimal leverage. We believe these companies will adhere to prudent financial policies, balancing growth and keeping their existing credit quality steady at the same time.

In Australia, despite volatile macro dynamics, the building materials industry continues to demonstrate resilience. We continue to see solid underlying demand for building products and good pipeline visibility. Recent data from the Australian Bureau of Statistics shows a relatively stable dwelling approvals trend. Nevertheless, effects from tighter monetary policy through 2023 could lead to softer market conditions in 2024 and weaken the credit quality of companies that are more exposed to new constructions.

Industry cash flows and margins in Australia could be hindered by cost pressures, labor shortages, and rising interest expenses in 2024. We also expect the industry will focus on more aggressive cost-cutting and structural cost-saving initiatives to offset inflationary pressures.

The operating environment in China was challenging in 2023. Weaknesses in the property sector re-emerged in the second quarter and was exacerbated by the default of one of the country's largest private real estate developers. In the first 10 months of 2023, newly started housing constructions experienced a year-on-year decrease of 23.2%.

Chinese building material producers' financial performance may remain sluggish in 2024 because demand could continue to be weak. The sector may not recovery meaningfully in 2024 as it continues to suffer from the fragile recovery of the Chinese property sector. We expect the number of constructions will be low, which could hamper the recovery in demand for building materials.

Profits of cement producers in China continued to decline drastically over the first three quarters of 2023 because of low selling prices, even in light of moderating energy prices. Tightening requirements on production rationalization failed to stabilize prices, with the average price of the national cement market experiencing a year-on-year decline of 15.2% over the first three quarters of 2023.

The recovery of China's property sales will be L-shaped over the next two years. We forecast property sales may decline by another 5% to renminbi (RMB) 11 trillion-RMB11.5 trillion in 2024, after a decline of 10%-15% in 2023. This is mainly due to the sluggish property demand in China's lower-tier cities. The delayed new construction starts could translate into a prolonged low demand for building materials.

Increases in infrastructure investments could support the building materials segment in China. Yet, we expect infrastructure investments will ease in line with economic growth over the next two years, after increasing to high single-digits in 2023. The moderating growth momentum in 2024 also results from more disciplined spending due to an increasing focus on debt risk and investment sustainability.

We expect the demand for building materials in South Korea will remain under pressure due to the weak domestic property market. The domestic construction market will remain subdued in 2024 as construction companies remain selective in their orders and property transaction volumes are low. High interest rates are also likely to weigh down on sentiment in the property market. Potential risks associated with project financing loans and the weaker credit quality of small and midsize construction companies could represent additional downside risks.

Credit metrics and financial policy

We forecast credit metrics of our rated companies will remain resilient in 2024, versus 2023. The satisfactory competitive position and sufficient financial headroom of most rated building materials companies in APAC will help them manage demand and keep their creditworthiness steady. In 2024, we expect our rated universe’s credit metrics should sit comfortably within their respective rating range.

The solid balance sheet of our rated issuers in China protects against a potential prolonged weakness in the demand for building materials. Margin recovery for Anhui Conch Cement Co. Ltd. (A/Stable/--) and Beijing New Building Materials Public Ltd. Co. (A-/Stable/--) could be gradual, even in case of moderating coal prices. Sluggish demand could continue to weigh on prices.

Our rated Chinese building materials producers' capex may remain sizable for business expansion, M&As, and investments in environment-related projects. Yet, their strong balance sheets will enable them to absorb spendings while keeping leverage low. We expect the issuers' financial policy will remain prudent because of industry headwinds. A deterioration in these companies' credit metrics is unlikely because they will refrain from aggressive expansions.

Our rated company in South Korea will likely maintain steady operating performance over the next two years. KCC Corp.'s (BB+/Stable/--) credit metrics could improve in line with its profitability. This is due to stabilizing raw material costs and its strong pricing power in the building materials business. KCC holds a leading position in South Korea's domestic building materials market and has the largest domestic market shares in coating and gypsum boards. Even so, KCC’s silicone business reported operating losses in 2023, which could weigh on its overall operating results over the next 12-24 months.

Our rated company in Australia maintains a strong balance sheet. This provides CSR Ltd. (BBB+/Stable--) with a material rating buffer to withstand softening building and construction activities in Australia. We anticipate the company's performance will be resilient in 2024, supported by the good short-term visibility of its sales. We also expect CSR will maintain strong free cash flows, which will support future capex for growth and property investments, as well as shareholder returns.

CSR also benefits from a conservative financial policy. Its adjusted leverage is below 1x since 2016. As of fiscal 2023 (year ended June 30), CSR has no interest-bearing debt on its balance sheet. In our view, this differentiates CSR from other investment-grade peers and provides the company with a sizable rating buffer to withstand industry shocks, without a material decrease in creditworthiness.

Key risks or opportunities around the baseline

1. Worsening property crisis in China slows demand recovery.

The Chinese building materials sector's downside risks largely result from the property sector. A further slump in the property sector will hit the resumption of construction activities. This could exacerbate the already challenging operating conditions in the sector, which struggles with low demand and a limited ability to pass on costs.

2. Moderating input costs could ease profitability pressure.

The pressure on profitability may start to ease as energy prices moderate after reaching peak level. The price of thermal coal, the major energy source and the key cost component for building materials producers, will reduce over 2024-2025.

3. Stricter environmental requirements will benefit industry leaders.

APAC lags Europe in carbon trading but more countries will likely introduce their own emission trading systems. The effect on the sector depends on the design of the schemes and carbon prices. Since our rated entities are generally industry leaders and generate less emissions than the industry average, they should fare relatively better than peers when a carbon tax is rolled out.

The Chinese building materials sector's downside risks largely stem from the property sector, which accounts for over one-third of the nation's cement usage. That said, we believe property sales are bottoming out. In our view, China's annual property sales could reach RMB10 trillion-RMB11 trillion in 2024. A decline in new property sales could prolong the decrease in new constructions and reduce demand for products and services from related downstream industries, including building materials and construction.

The pressure on margins will ease as energy prices decline. We expect thermal coal prices will moderate over 2024-2025 as demand in China, India, and other countries in Southeast Asia countries gradually peaks and demand from the EU and the U.S. declines. Thermal coal is the major energy source and the key cost component for building materials producers. Our price assumptions reflect our expectation that the global transition from coal-fired power generation will be protracted, as demonstrated by the current energy crunch.

Companies will continue to focus on managing costs through operational efficiencies, given inputs costs are still higher than average. The extent of recovery in profitability of Chinese players could lag its other APAC peers because the country's sluggish demand may keep prices low.

China's national carbon trading scheme was launched in July 2021 and currently only covers power producers. The government plans to also include other high-emission industries, such as building materials, steel, and petrochemicals. The effect of the national carbon trading scheme on cement producers is uncertain and depends on the government's allocation of carbon quotas and carbon prices, which are currently at about 10% of those in Europe.

Regardless of whether carbon quotas are allocated free of charge or at a cost, we believe our rated companies are better positioned than their peers. This is because their emissions are below the national average. Therefore, they are more likely to benefit from the introduction of carbon pricing because those that cannot meet national standards will likely shut down or be acquired by stronger players who can meet the standards.

Related Research

- Sanitary Plumbing Products Maker Geberit Outlook Revised To Negative On Weakening Credit Metrics; 'A+' Rating Affirmed, Nov. 27, 2023
- Credit FAQ: Tough Times Ahead for European Private-Equity-Owned Building Materials Distributors, Nov. 9, 2023
- SLIDES: EMEA Sector Update: Building Materials, Oct. 30, 2023
- Stanley Black & Decker Inc. Downgraded To 'A-' On Weaker-Than-Expected Performance; Outlook Negative, Aug. 23, 2023
- Compagnie de Saint-Gobain Upgraded To 'BBB+' On Strong Metrics Resilience; Outlook Stable, April 24, 2023
- Decarbonizing Cement Part One: How EU Cement Makers Are Reducing Emissions While Building Business Resilience, Oct. 27, 2022
- Decarbonizing Cement Part Two: Companies Could See Pressure On Ratings As The EU Firms Up Carbon Rules, Oct. 27, 2022

Industry Forecasts: Building Materials

Chart 20

Revenue growth (local currency)

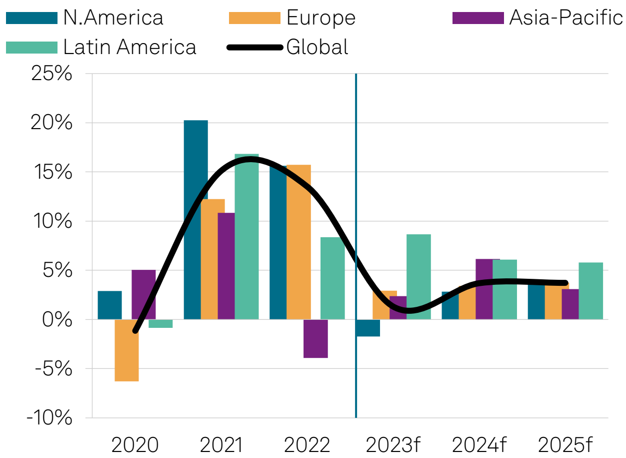


Chart 21

EBITDA margin (adjusted)

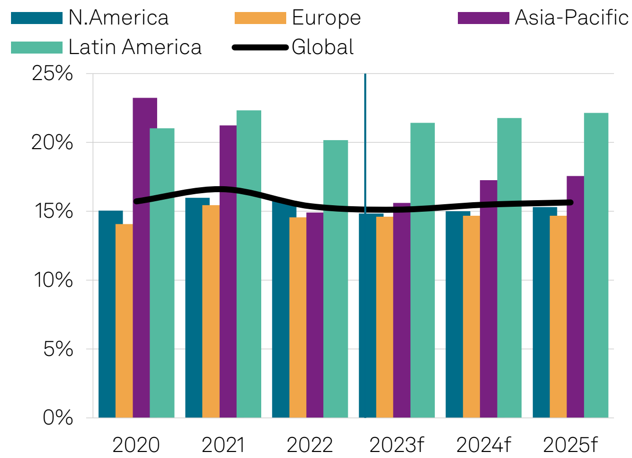


Chart 22

Debt / EBITDA (median, adjusted)

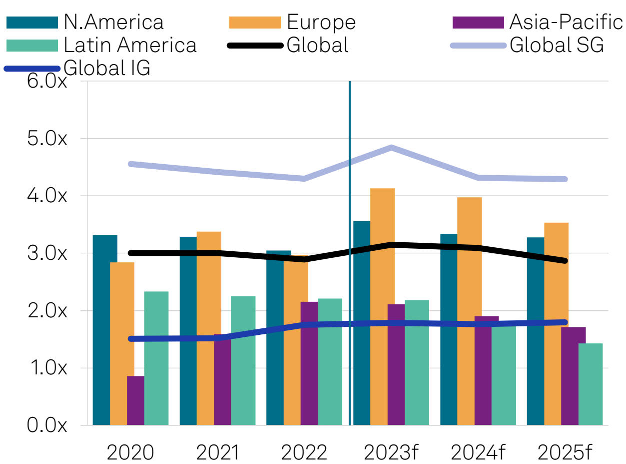
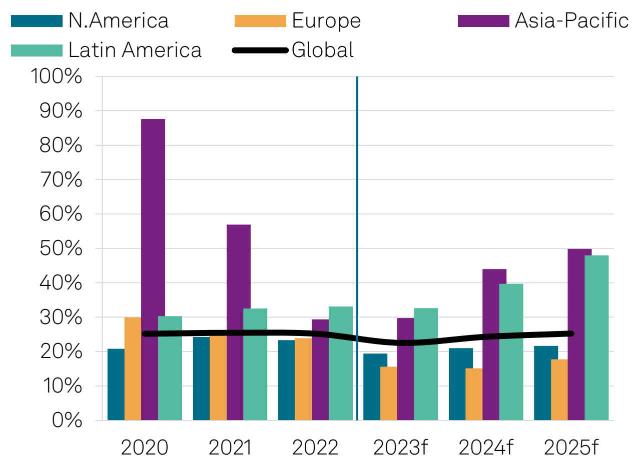


Chart 23

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = Forecast.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Building Materials

Chart 24

Cash flow and primary uses

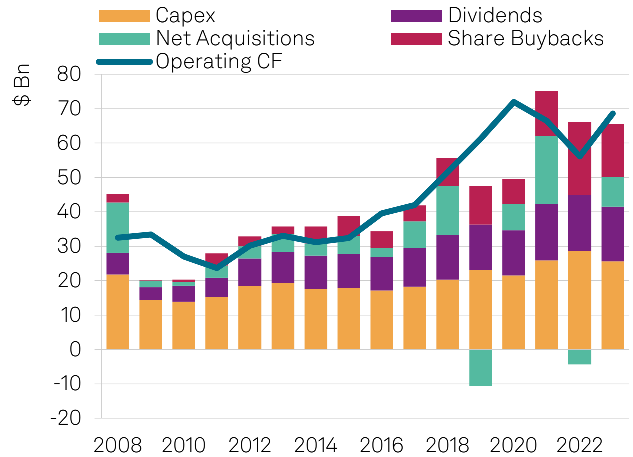


Chart 25

Return on capital employed

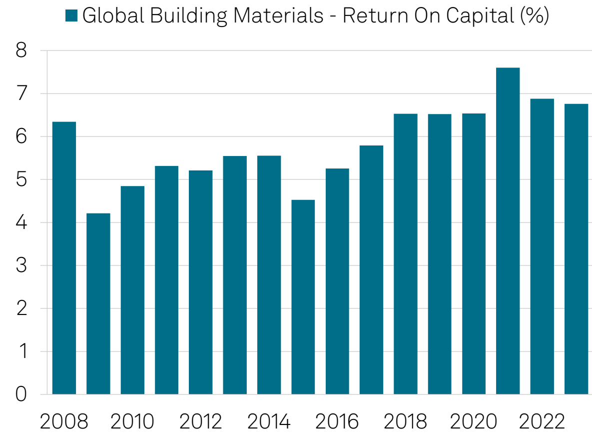


Chart 26

Fixed- versus variable-rate exposure

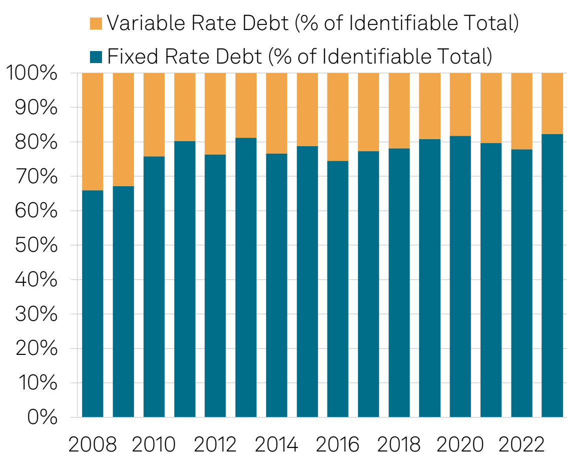


Chart 27

Long-term debt term structure

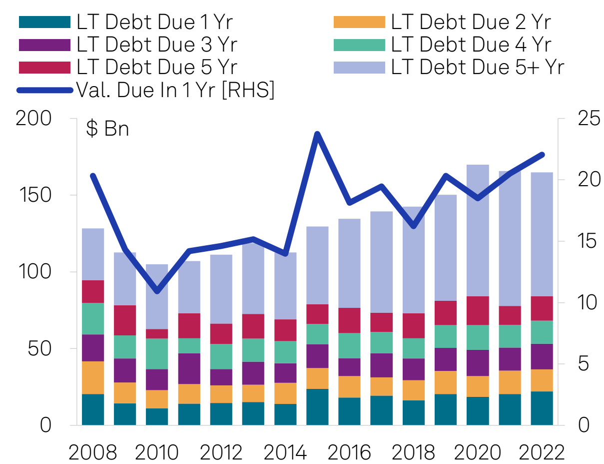


Chart 28

Cash and equivalents / Total assets

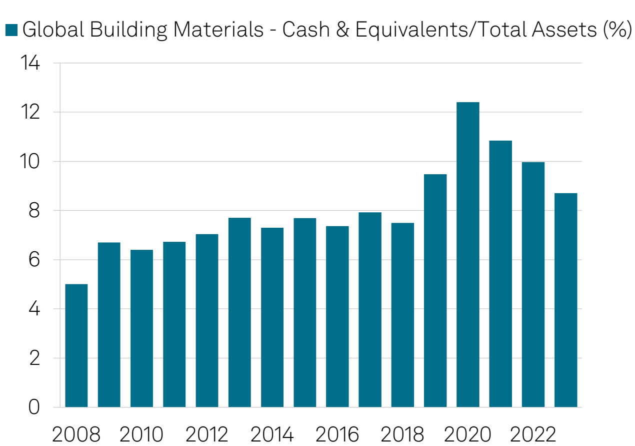
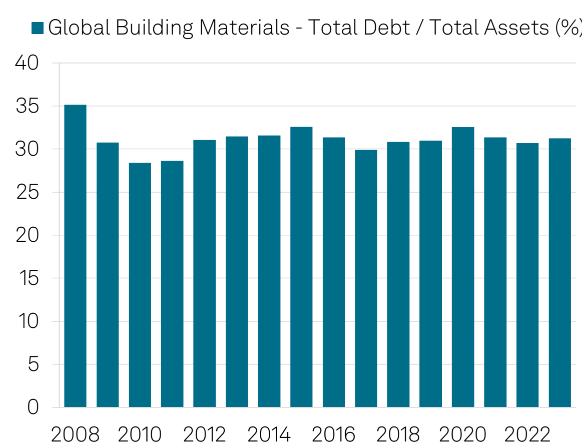


Chart 29

Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2023) figures use the last 12 months' data.