S&P Global
Ratings

Industry Top Trends 2022

Building Materials

Solid Demand May Not Suffice To Protect Margins Ahead Of Cost Inflation

This report does not constitute a ratings action

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What's changed?

Pricing strategies are key to offsetting much higher input costs. The scope of input cost inflation is extraordinary, and prices of key production inputs far beyond pre-pandemic. In Europe, energy costs are very high, also reflecting higher carbon taxes.

Credit quality has recovered to pre-pandemic levels, and a negative outlook bias became neutral in most regions, suggesting credit stability in 2022.

Increasing focus on environmental risk. The EU is at the forefront of carbon regulation. Its proposed 'Fit for 55' program allows a significant increase in carbon costs for the highest-emitting sectors, including cement.

What are the key assumptions for 2022?

Still steady demand for home repairs and infrastructure. Two years after the pandemic began, building materials has recovered quickly, and its prospects remain solid in 2022-2023, but with slower growth.

Higher raw material and energy costs put pressure on margins. Surging input costs put moderate or no pressure on margins in 2021, due to cost pass-throughs and positive operational gearing. Margin pressure will likely intensify in 2022, particularly for energy-intensive businesses.

Business confidence and cheap debt markets support M&A and shareholder-friendly policies.

What are the key risks around the baseline?

Persistently high cost-inflation or weakening demand would lead to severe margin decline. Our base case scenario points to lower energy costs and supply chain disruptions in the second half of 2022. If not, margins and cash flow may drop significantly in 2022.

Shareholders consume much of the credit buffer. Financial policy remains the most relevant driver of ratings. More aggressive behavior than we are currently assuming would likely translate into negative rating actions across both investment and speculative grade ratings.

Tighter carbon regulation may require higher capital spending. Some company commitments to cut emissions beyond 2030, particularly in the cement business, entail sizable investment to avoid paying higher carbon taxes.

Ratings trends and outlook

Global Building Materials

Chart 1

Ratings distribution

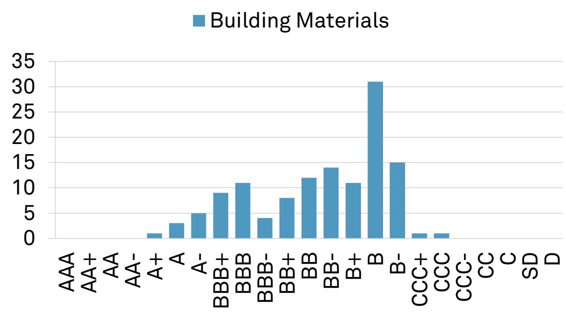


Chart 2

Ratings distribution by region

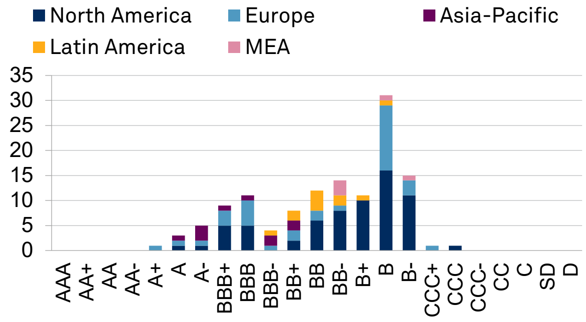


Chart 3

Ratings outlooks

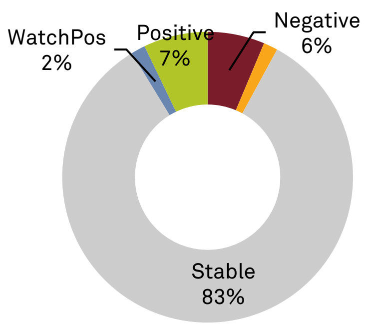


Chart 4

Ratings outlooks by region

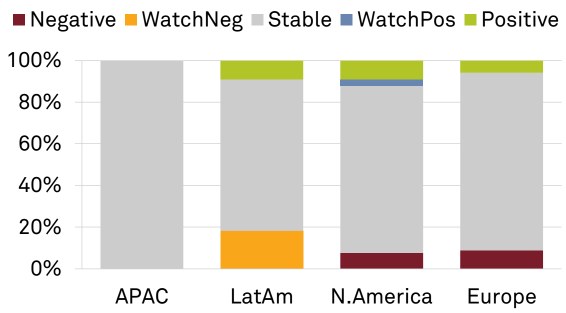


Chart 5

Ratings outlook net bias

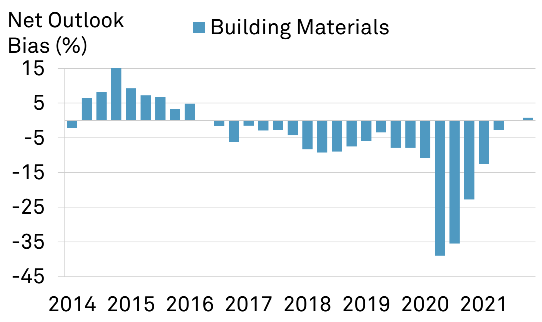
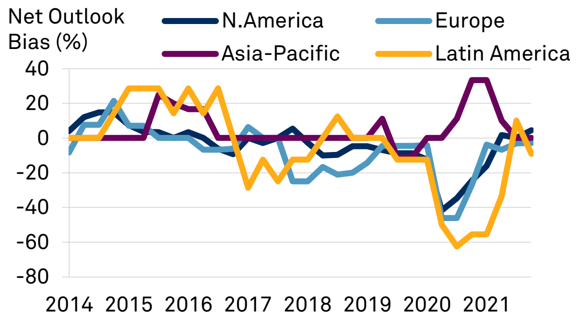


Chart 6

Ratings net outlook bias by region



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

North America

Ratings trends and outlook

We expect credit quality for North American building materials companies should remain stable through 2022 because about 80% of the companies have a stable outlook while 11% are positive and 8% negative. Companies with the ability to pass through cost inflation will have the best shot at hitting profit and leverage forecasts for 2022. A stable rating bias will nevertheless persist into 2022 because of strong end-market demand. Some portion of companies in the sector, however, have experienced elevated debt leverage due to leveraged buyout (LBO) transactions or dividend recapitalizations, resulting in a strain on their credit metrics that makes them susceptible to unexpected busines underperformance or restructuring costs. This was brought about by favorable business conditions resulting in strong profit growth and incremental cash flows that have been somewhat resilient or improved through the pandemic and are expected to remain in 2022 and possibly into 2023. For public companies, we have seen in most cases, the benefit of higher profits and incremental cash flows being directed toward shareholder returns. For a small portion, where excess free cash flow was used toward debt reduction, there have been some positive rating trends.

Main assumptions about 2022 and beyond

1. Solid demand for home repairs helps offset margin pressures

Market demand conditions are favorable, but commodity costs, labor, production, and delivery inputs remain headwinds for building material companies through 2022. The jump in commodity costs also coincides with higher transportation and logistics costs associated with supply chain constraints, which will test the industry's pricing power in 2022.

2. The U.S. infrastructure bill is a positive driver for construction spending over the next few years

Investment in infrastructure, such as aging power, roads, and water infrastructure, is on track for double-digit percentage gains this year. This could link to a positive trend in construction for future years, which will greatly benefit many companies within the building materials sector.

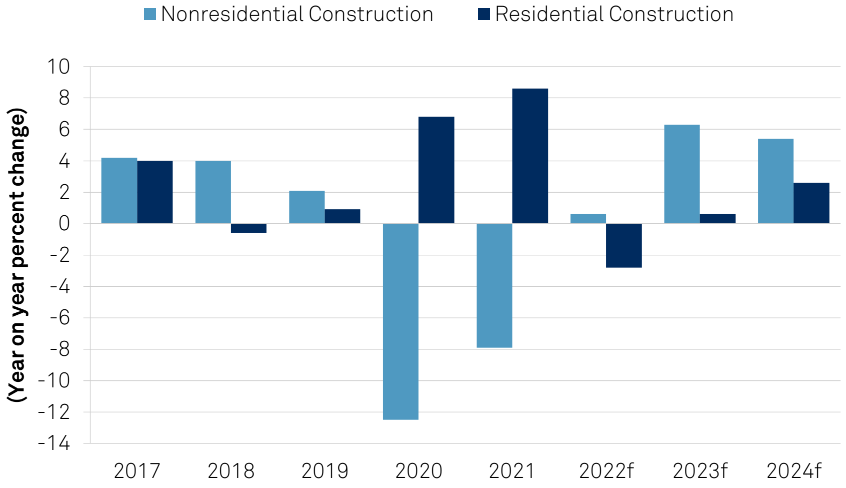
3. Tailwinds, fragmentation, and low interest funding drive mergers and acquisitions (M&A) and dividend recapitalizations

The North American building materials sector remains attractive for consolidation, as strategic and financial players consolidate regionally or diversify into new markets. Some of these transactions are yielding real credit benefits as stronger businesses improve pricing power and margins, but many LBO transactions have resulted in downgrades among our riskiest and lowest-rated credits. Low interest funding is also continuing to fuel the desire for private-equity owned companies within the sector to participate in dividend recapitalizations, increasing debt leverage expectations and creating additional pressure on many companies' credit measures.

Nonresidential construction has also seen double-digit percentage declines in private and public construction segments like lodging, education, manufacturing, and office (see chart 7). Nonresidential construction continued to be slower coming back throughout 2021, regaining only a portion of its lost ground from 2020. In addition, lower growth in residential investment and a shift in consumer spending could slow this unusual cyclical jump in demand.

Chart 7

U.S. Nonresidential And Residential Construction Forecast

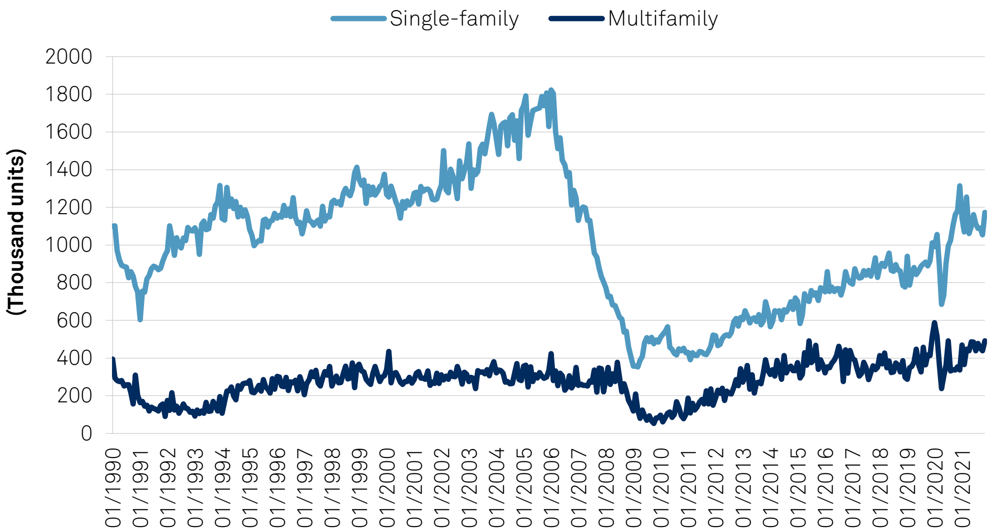


f—Forecast. Source: S&P Global Economics, [Economic Outlook U.S. Q1 2022: Cruising At A Lower Altitude], Nov. 29, 2021.

Nevertheless, continued low mortgage rates, a lower inventory of homes, and trends of deurbanization underlie the strength in residential construction activities. The favorable secular outlook for home repair and renovations supports continued good revenue predictability and more than offset margin pressure from the higher raw material costs and supply chain bottlenecks. Housing starts increased about 14% year over year as of November 2021 compared with 2020 and are forecast to be 1.5 million in 2022, up from a low of 554,000 in 2009. This level, which we forecast through year-end 2023, is the second-highest annual amount in the past seven years (see chart 8).

Chart 8

U.S. Housing Starts



Note: Multifamily starts are housing starts of 5-unit structures. Data as of January 2022. Source: Federal Reserve Economic Data.

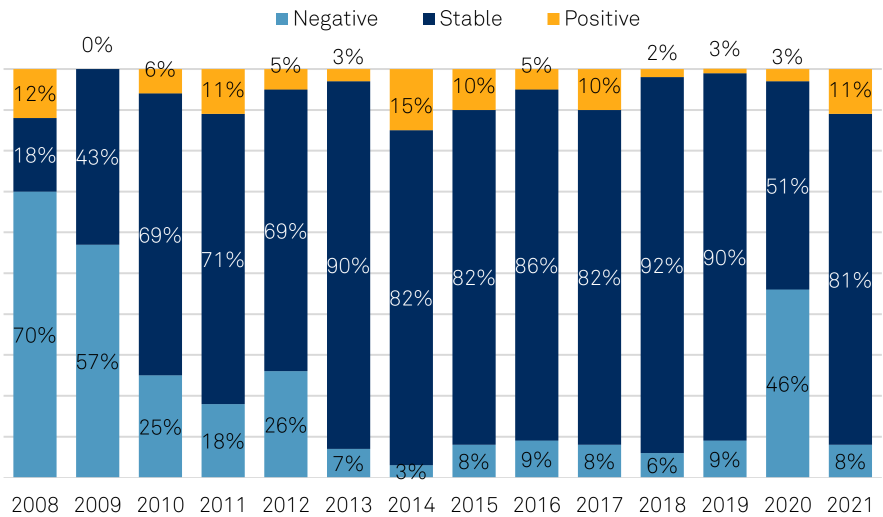
The Biden Administration's $1.2 trillion infrastructure bill passed in November 2021 is significantly smaller than the $2.25 trillion proposal that was unveiled through the American Jobs Plan. However, it is still the largest bill passed that includes investment for physical infrastructure and includes roads, bridges, water systems, electricity grids, broadband, and health care. This could link to a positive trend in construction for future years that will greatly benefit many companies within the building materials sector. Our economists estimate a 1.4x multiplier to the economy, meaning that a $1 trillion boost to public infrastructure spending could add $1.4 trillion to the economy over the project's duration.

Credit metrics and financial policy

About 80% of the outlooks in the sector were stable at the end of 2021, following rating actions reversing the initial pandemic-driven negative outlooks (see chart 9). The tailwinds from increased home investment, heightened repair and remodeling spending, and new homebuilding activity that began during the second half of 2020, continued to gain speed through 2021. We expect the combined effects of strong profit growth, favorable market conditions, pricing initiatives, and cost inflation and supply chain bottlenecks, to remain in effect through 2022. Based on attractive credit conditions, which we assume will continue in 2022, we believe aggressive financial policy actions such as debt-financed acquisitions or dividends will continue. Longer term, there could be some refinancing risks if cyclical changes such as notably weaker business and economic conditions were to coincide with higher debt leverage and pending debt maturities.

Chart 9

Rating Outlooks In U.S. Building Materials



Source: S&P Global Ratings.

Key risks or opportunities around the baseline

1. Commodity cost inflation and volatility could dampen the ability to pass through costs to consumers amid slowing demand

We believe the trend of robust volumes in home improvement and increased spending on commercial projects could face some headwinds as demand for commercial projects slows (given a shift in consumer spending) and noticeable cost swings in commodity prices for raw products, such as lumber, wood, metal, and oil, could result in some earnings and cash flow volatility. Passing through higher costs, which could reduce volumes and somewhat suppress otherwise strong financial expectations, will be instrumental for operating performance and resulting credit metrics. The extremely volatile demand-supply conditions can be seen, for instance, in lumber and metals prices. In 2021, lumber prices were 45% higher than in 2020 while the CMCI Industrial Metals Price Index is nearly 50% above its 2019 average, but about 5% lower than its record high in October. We expect these prices to remain elevated and susceptible to volatility in 2022.

2. Infrastructure spending growth could mean opportunities for building material companies

Given that many building material companies derive sales from public infrastructure construction end markets, a renewed focus of the Administration on the infrastructure bill could mean positive trends in future years. The pandemic has stretched local and government finances, but near-term bipartisan support of federal investment in U.S. infrastructure and future strategic spending plans for infrastructure are a great opportunity for many building materials companies. Repairs and upgrades in existing infrastructure, as well as investments in new infrastructure, will be some of the largest federal investments in history.

3. Attractive capital markets could lead to more M&A and shareholder-friendly actions, but rising rates could strain free cash flow generation

Credit markets have been willing contributors of capital to this industry’s consolidation, aggressively leveraging prospective cash flows from efficiency-improving M&A. High debt leverage and underperforming profits, in many cases among LBOs, leaves little cushion for a downturn or for shareholder returns. Building on our research since 2018, credit ratings have dropped for numerous leveraged new issuers in U.S. building materials, in contrast with favorable market conditions. Many LBO ratings had dropped before the pandemic and even though business conditions have since been good, few of these companies built sufficient cushion from their dividend recaps or acquisitions. Some issuers used stronger competitive positions from acquisitions to improve earnings and strengthen credit buffers, but those success stories often took years to unfold. Ambitious plans for debt-fueled consolidation in U.S. building materials haven't translated into higher ratings in most cases.

EMEA

Ratings trends and outlook

The building materials sector is posting widespread growth in most European countries. Credit quality has largely recovered to pre-pandemic levels, and negative outlooks receded to 11% in December 2021, well below the peak of 50% reached in December 2020. The current spike of raw material and energy costs will likely put pressure on margins in 2022, but it is unlikely to translate into negative rating actions in most cases, because rating headroom was restored to suitable levels. Instead, we believe that financial policies will continue to determine companies' creditworthiness and ratings, both in the investment grade and speculative grade category. Issuers across the ratings spectrum face a wide range of capital options, driven by climate transition, a high degree of market fragmentation, and shareholders' high payment hopes.

Main assumptions about 2022 and beyond

1. Building renovation and infrastructure are on a roll

According to Euroconstruct, construction volume in the EU should rise by 3.2% in 2022, after a rebound of 5.6% in 2021 and a drop by 4.7% in 2020. Sustained infrastructure works as well as the introduction of generous tax credit to promote building renovation, particularly energy insulation, and support a positive outlook in most European countries, in a context of economic growth and healthy business confidence.

2. Raised raw materials and energy costs put pressure on margins

The magnitude of input cost inflation in 2021 is extraordinary and has taken the prices of key production inputs, raw materials, and energy, far beyond pre-pandemic levels. Surging input costs translated into moderate pressure on margins in 2021, reflecting cost pass-throughs, hedging, and positive operational gearing. However, margin pressure will likely intensify in 2022, particularly for most energy-intensive businesses. Still, we expect EBITDA margins to remain at healthy levels within the cycle.

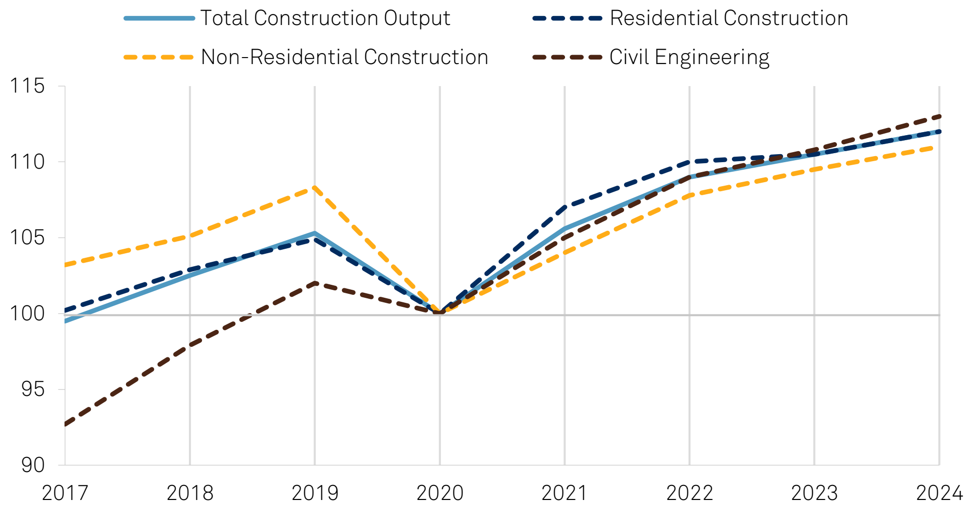
3. Business confidence continues to support capital expenditures (capex) and M&A

We anticipate capex growth of 4% in 2022, which follows a remarkable 30% rise in 2021 and a drop of 19% in 2020. Supportive business confidence and climate transition risks are currently key drivers of companies' investment decisions. Acquisitions have also surged on both the investment-grade and speculative-grade rating level, supported by cheap debt. As such, we expect limited or no financial deleverage in 2022.

Two years after the start of the pandemic in Europe, we can reasonably affirm that construction is among those sectors that have recovered quickly and whose prospects remains solid in 2022-2023. According to Euroconstruct, construction output in 2021 is set at €1.74 billion, which already represents a fully recovered loss compared with 2019, thanks to an important jump of 5.6%, and market consensus expects the European construction sector to post further cumulative growth of more than 5% in 2022-2023 (see chart 10). Most growth in 2021 was ascribed to residential renovation and to a lesser extent, to infrastructure. We anticipate that in 2022-2023 growth will be a bit more balanced among residential, non-residential, and infrastructure construction. In this context, it is not a surprise that the building material sector is posting a solid performance, reflecting both volume growth and a positive pricing environment.

Chart 10

Construction Output By Sector (EC -19, Index, 2020=100)

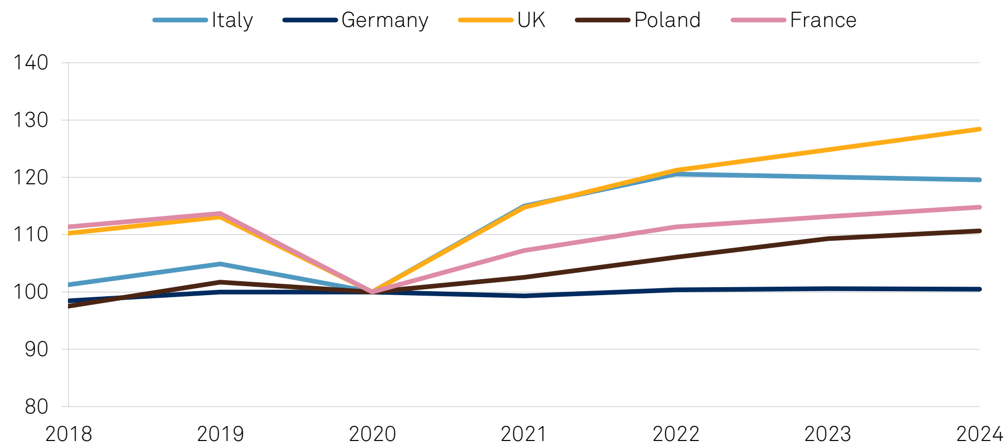


Source: Euroconstruct.

At a country level, the picture is less homogeneous (see chart 11). In some countries, such as Italy, the pre-crisis level has already been significantly overtaken, largely thanks to generous tax stimulus to promote green building renovation. In other countries, such as France, the gap on pre-crisis should be filled in 2022 while Germany and Poland displayed less volatility during the pandemic. It is also worth highlighting the significant rebound of the U.K. construction sector in 2021, which should stay healthy in 2022-2023, largely reflecting a positive contribution from the infrastructure segment.

Chart 11

Construction Output By Country (Index, 2020=100)



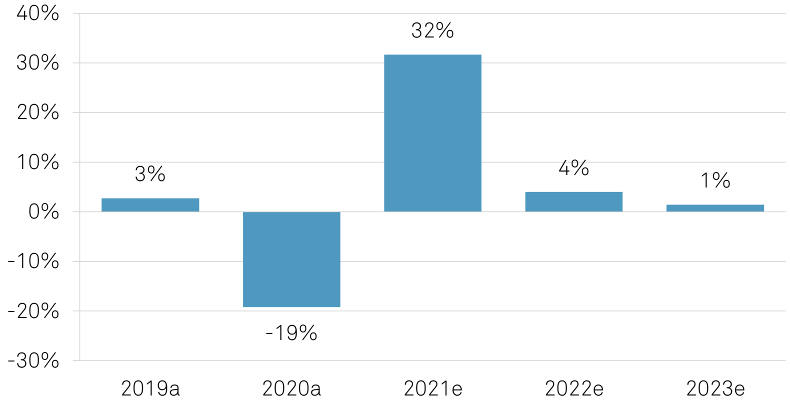
Source: Euroconstruct.

Surging input costs translated into only moderate pressure on margins in the first nine months of 2021, reflecting cost pass-throughs, hedging, and positive operational gearing ahead of solid demand for building products, particularly in the residential renovation market. For the whole of 2021, we anticipate that European building materials EBITDA margin will have only marginally dropped compared with 2020, still at a very solid level within the cycle (see chart 14). However, margin pressure will likely intensify in 2022. This is because the magnitude of input cost inflation is extraordinary and has taken the prices of key production inputs, raw materials, and energy, far beyond pre-pandemic levels. Furthermore, some energy sources' prices further and remarkably rose in the fourth quarter of 2021. For example, natural gas in the European wholesale spot market posted growth in excess of 4x. We anticipate that natural gas' and other energy sources' prices will remain high at least during the first half of 2022 and eventually decrease in the second part of the year. Partially mitigating our concerns, most European-based building material companies have significant operations outside Europe, where the pressure on energy bills is comparatively less. Furthermore, for high energy consuming companies, the energy mix in Europe includes a significant contribution from alternative fuels, whose price has not followed the same trend as fossil fuels. Still, we believe that building material companies' energy bills in 2022 may eventually double compared with 2021. In such a context, we anticipate that most companies will continue adopting a pass-through model for commodity inputs to buffer the largest portion of any cost increase, as they did in 2021. Some companies are also updating their commercial strategy by introducing steep price changes to compensate for high energy and high carbon costs. Nevertheless, companies may suffer from some time lag to offset inflation costs. Furthermore, in 2022 operational gearing will not be as supportive as it was in 2021. As such, we anticipate that in 2022 average EBITDA margin will decline, but remain marginally above the 2019 level (see chart 14). However, it is likely that EBITDA margin related to heavy-side building material companies, such as cement, will drop below the 2019 level, given the comparatively higher weight of energy bills in their cost base.

Recovered business confidence supports capex and M&A. We anticipate that capex will have grown by about 30% in 2021, after a drop by 19% in 2020, and that it will progress by 4% in 2022 (see chart 12). Most building material companies prioritize investments in those business segments with higher growth potential and less climate transition risk. ESG is also at the core of cement companies' capital allocation because those companies are assigning an increasing share of their maintenance capex to improve plants' thermal efficiency while cutting CO2 emissions.

Chart 12

Capex Trend (% Change Year On Year)



a—Actual. e—Estimate. Source: S&P Global Ratings.

In 2021. M&A also surged at both the investment-grade and speculative-grade rating level, supported by cheap debt. Most acquisitions have been bolt-on or midsize, aiming at improving footprint in existing profitable markets or in those segments that are beneficiaries of government stimulus. Furthermore, companies are prioritizing investments to address the future needs of construction, such as large-scale horizontal construction, and to reduce their exposure to climate transition risk. At the same time, companies are also pursuing divestments, typically small size, to exit non-strategic markets or decreasing group complexity. As result of sustained capex and M&A, we anticipate no or limited financial deleveraging in 2022.

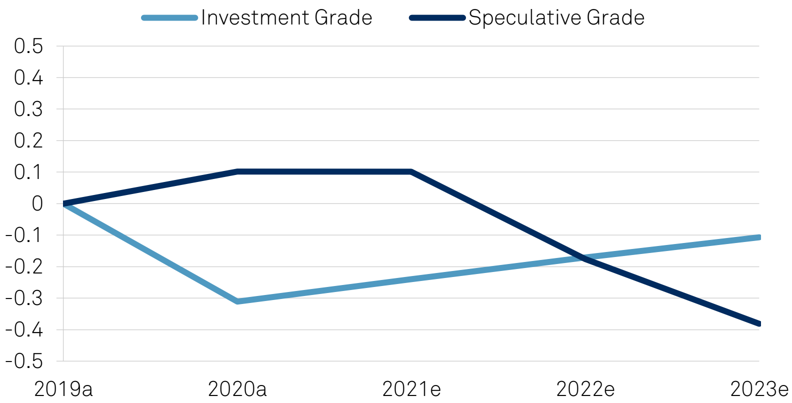
Credit metrics and financial policy

Credit metrics for investment-grade companies have slightly improved during the pandemic, leaving room for M&A and shareholder distribution in 2022. The COVID-19 pandemic and related effects on the economy have not significantly impaired the performance of the major European building material companies. In particular, demand remained very healthy in the residential renovation, maintenance, and improvement segment. In 2020, building material companies cut or postponed their dividends, and those with share buybacks in place suspended them. As a result, average adjusted leverage for investment-grade companies slightly improved to 1.4x in 2020 from 1.7x in 2019 (see chart 13). The ongoing strong demand also helped the companies pass through raw material price inflation in 2021. At the same time, companies resumed shareholder remuneration, leading to broadly stable credit metrics, on average. Several investment-grade companies have solid rating headroom at the end of 2021, such as CRH and HeidelbergCement, which could lead to higher M&A activity or shareholder remuneration. Some issuers already made announcements in this regard. For example, Saint-Gobain announced that it will acquire GCP Applied Technologies in 2022, and HeidelbergCement decided on a share buyback program with a total amount of up to €1 billion. While companies could use their rating headroom, we believe they remain committed to the current rating, and we do not anticipate negative rating actions.

Speculative-grade companies' adjusted leverage remained broadly stable in 2020-2021. Like investment-grade companies, speculative-grade companies were mildly affected by the pandemic in 2020-2021. Average revenue and profitability have improved in 2021, overcoming 2019. However, private equity-driven financial policies continue to constrain companies' financial risk profiles, through dividend recapitalization or acquisitions. In 2021, about one-third of companies in the 'B' rating category paid dividends to their private equity owners, reflecting benign financial and operating conditions. As result, we anticipate a slight increase in financial leverage in 2021. On average, adjusted leverage of 'B' rated companies is high, at about 6.5x, and some companies have limited rating headroom. That contrasts with 'BB' rated companies, which are not owned by financial sponsors and which have seen, overall, a financial leverage improvement in 2021. We expect leverage to improve in 2022 for speculative grade companies, on average, supported by robust cost controls, successful integration of acquired entities, and realization of synergies. Our base case scenario does not encompass dividends or transformational M&A for private equity-owned companies because they are generally uncertain in size and timing.

Chart 13

Debt To EBITDA Change By Rating Category (Base=2019 Levels)



a—Actual. e—Estimate. Source: S&P Global Ratings.

Key risks or opportunities around the baseline

1. Persistently high cost-inflation would lead to a severe margin decline

Our base case scenario for the ratings points to a decrease of energy costs in the summer of 2022, which would ease the pressure on margins in the second half of 2022. However, if currently high energy prices persist over 2022, particularly natural gas and electricity, or if cost inflation spreads to labor, building material companies' margins and cash flow would significantly decrease in 2022-2023. This may result in negative rating actions in a few instances.

2. Shareholders consume much of the credit buffer

Financial policy remains the main driver of future rating actions. Both private equity owned and listed companies have already restored their equity remuneration to pre-crisis level, leveraging the sector's rapid recovery. For example, during the first half of 2021, about one-third of companies in the 'B' rating category paid dividends to their private equity owners and most investment-grade companies introduced or restored their share buy-back programs.

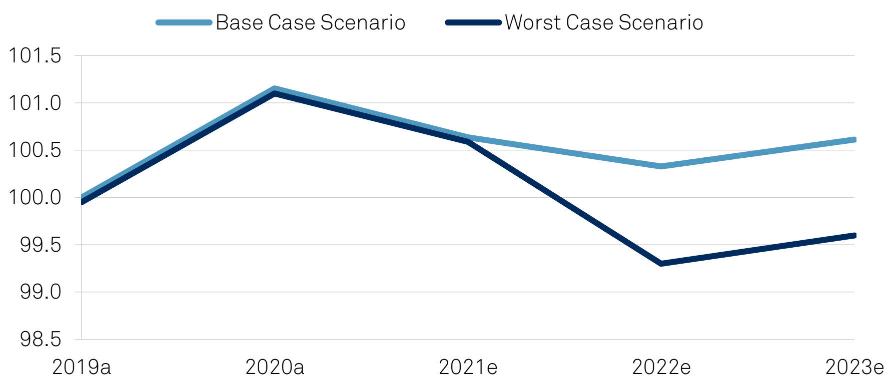
3. Tightening of carbon regulation puts pressure to cement companies

Cement companies' high intensity ratio may burden their business and financial profiles if they are not able to significantly cut emissions. The proposed EU package "Fit For 55" may entail a quick phase out of the free CO2 allowances starting 2024, thus widening cement companies' carbon certificate deficit and meaningfully increasing their CO2 costs. Companies will likely have to significantly raise prices to protect profitability margins.

Rising inflation is a downside risk to our base case assumptions. So far, most building material companies have been able to pass through raw material and energy price increases, helped by robust demand, especially in the renovation end-market. If upward pressures on energy bills were not to ease in the second half of 2022, business and consumer confidence would most likely weaken, thus making it more difficult to pass through costs. In such a scenario, companies' sales would most likely slow, and EBITDA margin would drop compared with our base case scenario and stay below 2019 level for the whole sector (see chart 14). Eventually, this may result into negative rating actions in a few instances, namely when companies operate in competitive sub-markets or have exposure to long-term projects.

Chart 14

Adjusted EBITDA Margin (Index, 2019=100)



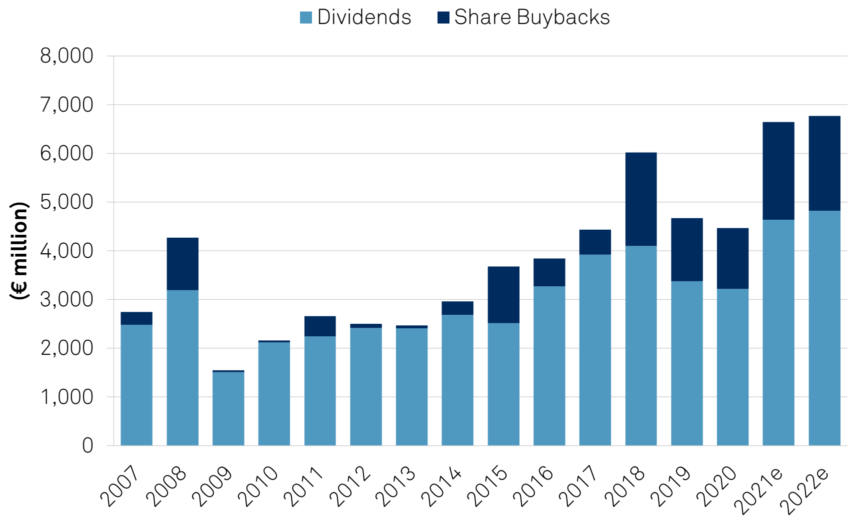
a—Actual. e—Estimate. Source: S&P Global Ratings.

New lockdowns due to the resurgence of COVID-19 infections are a downside risk because it could lead to a drop in demand. However, we believe that the building materials sector is less exposed to COVID-19 hindrances than other sectors such as retails or transportation. In fact, in 2020-2021 many issuers saw an increase in demand for building products and solutions targeted to renovation and home improvement.

Aggressive financial policies remain among the main risks that could impair ratings. Both private equity-owned and listed companies have already restored their equity remuneration to pre-crisis level, leveraging the sector's rapid recovery. Shareholder remunerations of the largest European building materials companies reached a record level in 2021, reflecting both increased dividends and the restoration of or new set of share buy-backs (see chart 15). We anticipate the trend to continue in 2022, reflecting the overall solid performance in 2021. We see also a risk of increased financial leverage of private equity-owned companies if they pursue further dividend recapitalization, following those made in 2021, or if there is a change in ownership. Should companies conduct more aggressive financial policies, a few ratings may be at risk. That said, most investment-grade companies are committed to the current ratings, therefore we see a higher risk of rating actions in the speculative grade category.

Chart 15

Largest European Building Materials Companies' Shareholder Remuneration



e—Estimate. Companies include Buzzi Unicem, Compagnie de Saint-Gobain, CRH, Geberit, HeidelbergCement, LafargeHolcim, Legrand, Rexel, and Wuerth. Source: S&P Global Ratings.

Cement production is responsible for about 8% of the global CO2 emissions. The proposed EU 'Fit for 55' program paves the way for a significant increase of carbon costs for the highest-emitting sectors over the next five years, including cement. The package proposes increasing that 2030 target to a 55% reduction (versus the 1990 level). The implementation of this higher target would tighten annual caps and thus lower supply of free carbon allowances. Furthermore, starting 2024, the EU is proposing to introduce a carbon border adjustment mechanism to protect the EU's local cement production from carbon leakage as an import from neighbouring countries, but this would be accompanied by a progressive removal of free allocations. Regulation in the other geographic regions is limited at this stage, but the picture may change soon.

Raising carbon costs may affect cement manufacturer's profitability in the medium term. Currently, cement companies' profitability is at healthy levels, due to sustained demand ahead of solid construction backlogs. In our base case scenario for the ratings we foresee a significant cement price increase in those regions with carbon taxes, to offset higher carbon costs. However, we see two main risks over next few years:

- Regulation extends to China and the U.S., which would lead to higher carbon costs also outside the EU.
- Companies prove unable to pass through higher carbon costs due to structurally declining cement demand or because the carbon cost is higher than in our assumptions.

Mitigating our concerns, we believe cement substitution alternatives are limited and demand should remain structurally steady, which should enable companies to increase prices. In addition, cement manufacturers made ambitious commitments to reduce their CO2 per ton of cement (see table 1). Energy efficiency remains the most relevant factor that drives emissions reduction until 2030, when most large groups have put targets to cut emissions to below 0.5 ton per cement ton. Beyond 2030, to achieve carbon neutrality a significant drop of emissions can only be achieved by wider use of carbon capture and storage--which is a technology that today is still under demonstration or at the prototype stage and that requires significant infrastructure investments to scale--and by increased use of recycled or low-clinker materials, which embeds a reshape of construction value chain as well as wide end-users' acceptance. As of today, it is hard to assess if some companies' commitment to carbon neutrality by 2050 is feasible. That said, leading cement manufacturers are investing heavily in these new technologies and already envision some benefits before 2030. For example, HeidelbergCement publicly communicated that its current carbon capture and storage projects may save up to 10 million tons of CO2 by 2030, which represent about 15% of its current total emissions.

Table 1

Europe-Based Cement Players' CO2 Emissions And Intensity Ratio

	Buzzi Unicem	Cementir	CRH plc	Heidelberg Cement	Holcim Ltd.	Titan Cement
Net CO2 emissions (kg per ton of cementitious material)						
2019	688	696	590	589	561	677
2020	694	718	573	576	555	674
Target (date of target)	662 (2022)	577 (2025)	520 (2025)	500 (2030)	475 (2030)	506 (2030)
2020 intensity ratio (sales per ton of CO2, Scope 1)	5406	6484	1509	3862	5144	6160
Commitment to carbon neutrality (date)	No	Yes (2050)	Yes (2050)	Yes (2050)	Yes (2050)	Yes (2050)

Source: S&P Global Ratings.

Latin America

Ratings trends and outlook

Credit quality for the vast majority of Latin American (LatAm) building materials entities should remain broadly steady through 2022. As of January 2022, close to 70% of our rated portfolio in the sector has a stable outlook. In 2021, companies have returned their credit metrics to pre-pandemic levels or even healthier levels. This was underpinned by favorable industry conditions in most LatAm markets, profit margin expansions, prudent financial policies, and a focus on maintaining healthy liquidity positions. For 2022, we expect revenue growth to plateau between 0% and 5% compared with 2021, thanks to still favorable supply/demand conditions, particularly in the informal sector, that will continue to benefit from a high level of remittances, home improvements, and government social programs. However, downside risks remain elevated in the region, particularly because we expect slow GDP growth, a rising inflation and interest rate environment, and a still-weak labor market dynamic. Supply chain disruption and the surge of new cases from the omicron variant of the coronavirus are also risks that we will continue to monitor for the sector. As a result, we will keep an eye on the sector growth trajectory and potential margin pressures. The region will also face heavy election cycles in some countries such as Brazil and Colombia, and still uncertain and unfavorable policy directions in other countries like Peru and Mexico, that will likely keep investments subdued.

Main assumptions about 2022 and beyond

1. Industry growth prospects to slow in 2022 due to high comparison base

Our forecast suggests that LatAm building materials companies' growth prospects will slow down in 2022, likely in the 0%-5% range, due to the high comparison base from 2021. Solid demand from the informal sector, spurred by high level of remittances, home improvements, and government social programs, should remain the main engine of growth.

2. Profit margins to remain relatively steady despite higher inflation

Management strategic initiatives will be key to hold EBITDA margins steady during 2022 given ongoing cost inflation, supply chain disruption, and foreign exchange rate volatility.

3. Credit metrics to stabilize amid prudent financial policies

We foresee credit metrics stabilizing or slightly improving in 2022 amid resilient top-line growth, steady EBITDA margins, and prudent financial policies.

In 2022, we expect most LatAm countries to return to their traditionally low GDP growth rates and to face the same structural economic challenges as before the pandemic. As a reference, we expect LatAm's six largest economies to grow 2% in 2022 and 2.3% in 2023, from 6.6% in 2021 and a 6.8% contraction in 2020. Overall, we expect the sector to face slow growth, high inflation and interest rates environment, electoral cycles, and subdued investments. Following double digits volume and top-lines growth in the industry during 2021, our forecast for the next 12-24 months now suggests that building materials companies will return to slow volume growth, mostly underpinned by the informal sector and a price increase at least at inflation levels to contain inflationary pressure on profit margins.

In Brazil, we expect building materials companies' revenue growth to slow in 2022 due to an anticipated slowdown in demand and slower increase in prices, mostly because of rising interest rates, inflation, and unemployment, which could also increase competitive pressures. After a solid rebound since mid-2020, both in terms of volumes and prices, Brazilian domestic cement sales have already shown signs of slowing since October 2021, and we expect this trend to accelerate during 2022. Cement sales reached 64.3 million tons in 2021, still 6.4% above the same period in 2020, but yet below the double-digit percentage growth rates observed from December 2020 to September 2021. In 2022, we expect lower demand from the informal sector amid macro-economic pressures, as well as a deceleration in housing launches. This might be partially compensated by increasing demand from infrastructure, for instance, related to new sanitation projects. Still, we could see some delays in investments due to the electoral cycle.

In Mexico, the sector grew at double-digit percentage rates in 2021, and we still expect favorable supply/demand conditions in 2022, with a robust level of capacity utilization (near 80%). For the last 12 months ended October 2021, cement production reached 52 million tons, 12% and 14.3% increases compared with the same period in 2020 and 2019, respectively. Due to the high comparison base from 2021 and slower GDP growth prospects for 2022, we anticipate building materials companies' revenue growth to slow, on average, in the low- to mid-single-digit percentage area. As seen over the past few years, we think growth will remain mostly underpinned by the informal sector that should continue to take advantage of a high level of remittances, home improvements, and government social programs. On the other hand, we still expect a limited number of large infrastructure projects due to restricted policy responses and weak private investments, but activity in the industrial sector has been picking up in recent quarters, primarily due to the development of warehouses, manufacturing facilities, and distribution centers throughout the country. Moreover, the tourism sector is gradually recovering, and we expect projects postponed during the pandemic to restart. We also expect the formal housing sector to confirm its modest rebound, with housing starts likely to approach 180,000 units in 2022, after record low levels of unit production due to the pandemic and a historically low subsidy level in 2020.

In Peru, national cement production reached 12.9 million tons in 2021, 40.6% and 21.6% increases compared with the same period in 2020 and 2019, respectively. For 2022, we still expect the sector to endure favorable industry momentum but companies' revenue growth to slow, in the 0%-5% range, due to a high comparison base from 2021, but still supported by our expectation of favorable informal construction activity and ongoing infrastructure projects, mostly related to the reconstruction agreement between Peru's and the U.K.'s governments, that should at least last until 2023.

Our base case scenario also suggests that most LatAm building materials companies should hold their EBITDA margins broadly stable in 2022, despite our expectation for higher cost increases. Despite inflationary headwinds due to the surge in energy prices, limited labor availability, and freight challenges, we expect proactive risk management initiatives for hedging some input costs, as well as price adjustments to pass through cost increases to customers to protect their profit margins. These, coupled with our expectation of prudent financial policies, should allow credit metrics to remain broadly stable or even to slightly improve in 2022.

Credit metrics and financial policy

As expected, LatAm building materials companies returned credit metrics to pre-pandemic levels or even healthier levels in 2021. Pent-up demand for building materials products amid favorable supply/demand dynamics triggered double-digit percent volume growth across the region while entities implemented active pricing adjustments, which not only led to a significant increase in revenue but also triggered profit-margin expansions. At the same time, companies maintained prudent financial policies that, combined with solid EBITDA growth and a healthy level of liquidity, strengthened their credit metrics. For 2022, we expect credit metrics to remain broadly stable or to slightly improve in some cases, but at a lesser pace than in 2021. We assume a normalization in revenue growth and profit margins to hold relatively steady, despite inflationary pressures on operating costs and a higher interest rate environment. In that context, we foresee entities maintaining prudent financial policies toward investments, including capex and bolt-on mergers and acquisitions, if any; dividend payments; and share buybacks. Overall, we expect rated building materials companies will maintain adequate liquidity positions, with limited debt refinancing risks in 2022.

Key risks or opportunities around the baseline

1. Political and economic risks will weigh on sector growth prospects

Ongoing political and economic risks in the region pose downside risks to our growth projection for building material companies. Moreover, the surge of cases from the omicron variant of the coronavirus and potential for more widespread mobility restrictions could also increase downside risk.

2. High inflation and tighter financing conditions could undermine margins

An extended period of high inflation in the region, coupled with tightening financing conditions, could pressure profit margins and credit metrics beyond our current estimate.

3. Carbon tax regulation is progressing slowly, but we expect greater investments over next few years

In LatAm, it is still unclear how and when upcoming carbon tax regulations will be implemented but building materials companies will have to accelerate their investments to reduce their CO2 emissions.

LatAm building materials companies will, once again, face several political and economic risks that will keep downside risks to growth high in 2022. The combination of slow GDP growth, high inflation, supply chain disruption, and still-weak labor market dynamics, amid a heavy electoral cycle, will increase demands for continued fiscal stimulus measures. In our view, this could add more upward pressure on interest rates to compensate for the associated higher fiscal risk premia and will likely keep investment subdued. Moreover, the heavy election cycles in countries like Brazil and Colombia and still uncertain and unfavorable policy directions in other countries like Peru and Mexico, could limit and/or delay investments. Although several LatAm countries will continue to take advantage of the U.S.' strong economic recovery, through high remittances levels, we believe that the state of the economy in most countries, across the region, could also add downside risks to our growth projection for the sector. Moreover, the surge of the omicron variant of the coronavirus and potential for more widespread mobility restrictions could also increase downside risk.

In Brazil, we believe that uncertainty over 2022's general election could result in delayed to investments. This, coupled with the impact of supply-chain disruptions on manufacturing, abrupt monetary tightening in the face of persistently high inflation, and a more challenging fiscal scenario, will add downside risk to our 0.8% GDP growth expectation in 2022. In Mexico, the investment outlook outside of the manufacturing sector remains downbeat, partly due to government policies that have undermined investment incentives in key sectors. Although, the building material sector will continue to benefit from a strong U.S. recovery, which will continue to filter through record-high remittances, additional growth seems to be limited. In Peru, we think that the removal of fiscal stimulus measures will also soften domestic demand next year. There is also a lot of uncertainty over policy direction since the largely unknown anti-establishment candidate Pedro Castillo became the new president. In our view, this will cause investors to be more cautious about the country until they have more information about the new administration's policies.

Moreover, an extended period of high inflation in the region, coupled with tightening financing conditions, could pose downside risks to building materials companies' profit margins. If these risks materialize and persist, this could quickly undermine building materials credit metrics beyond our current estimate if no sufficient countermeasure are implemented.

Progress on CO2 emission regulations and ETS (Emission Trading System) in LatAm is still lagging behind markets like those in the EU. Specifically, in countries where our rated entities have operations, mostly in Brazil, Mexico, Peru, and some central American countries, CO2 emission regulations have not yet been enforced. In most of these countries it is still unclear how and when upcoming carbon taxes regulations will be implemented. Thus, it is still difficult to have a clear view on how this could affect LatAm building materials companies' cost structure and potentially their credit quality. Yet, most of the issuers we rate are already taking actions to reduce their annual CO2 emissions, including increasing blended cement; using alternative fuels; using more gas and less carbon; and in some instances, reducing their clinker factor while increasing cement prices due to the positive momentum in the sector. Over the next few years, we expect investments related to CO2 emissions reduction to increase to meet with domestic regulations.

Asia-Pacific

Ratings trends and outlook

All of our rated building materials companies in Asia-Pacific (APAC) have a stable outlook, indicating resilient credit quality even during the pandemic. This is due to both the rating buffer built in previous years and the relatively faster recovery of the region, especially China.

We forecast economies in APAC will continue to recover in 2022, but at a slower rate than 2021 given the low base in 2020. This will support the demand for building materials in the region.

Key risks include a resurgence of COVID-19 leading to a slowdown in construction activities and rising costs hitting margins. In China, the government's control of leverage of both property developers and local governments may lead to weaker construction activities. The government may support the economy through infrastructure investments but that depends on the government's tolerance for economic growth.

Our rated companies have maintained a disciplined investment appetite during the pandemic without significant acquisitions or capital expenditure (capex). We expect this trend to continue in 2022, given the high uncertainty of the macro-environment.

Main assumptions about 2022 and beyond

1. Moderation in economic growth in 2022

Our economists forecast overall GDP growth in APAC will decelerate to 5.1% in 2022 from 6.7% in 2021 due to a low base in 2020. Among countries with rated companies, we forecast Australia's economic growth will slow down to 3.5% in 2022 from 3.9% in 2021, China to 4.9% from 8.0% and South Korea to 2.7% from 3.9% over the same period. Yet the slower economic growth will support 0%-5% revenue growth for our rated building material companies.

2. COVID-19 not to materially disrupt construction activities

We acknowledge that regional lockdowns and other pandemic-induced social distancing measures may lead to a slowdown in construction activities and therefore demand for building materials. However, we believe governments in the region do aim to maintain normal economic activities. Therefore, we do not foresee widespread suspension of construction activities in the region.

3. Rated companies to maintain investment discipline

We expect our rated entities to maintain a disciplined investment appetite due to macro uncertainty despite their rating buffer. They are usually the industry leaders, with stronger balance sheets. Therefore, they are not in dire need of mergers to weather industry adversity. Instead, they aim to solidify their market position while maintaining profitability.

In Australia, the cessation of construction-related COVID-19 lockdowns in the second half of 2021, together with buoyant detached residential and infrastructure construction, is offsetting continued demand weakness in high density residential construction and contributing to an improving demand outlook for building materials suppliers. However, we expect ongoing supply chain constraints, labor shortages, and high raw material costs to continue to drive construction delays and cost pressures in 2022, tempering earnings growth and margins.

In China, the government's tightened control on the leverage of property developers and local governments led to a decline in new property starts in the fourth quarter of last year. Despite marginal improvement in funding conditions for property developers recently, we believe the government's goal is to avoid the spillover effect of individual property developers' liquidity problems turning into systemic risk. The government is asking stronger industry players, including state-owned and better-managed private developers, to acquire property development projects from weaker companies that need cash.

The first quarter is generally the low season for construction activities in China due to the Lunar New Year. If property development remains subdued, the government may support the economy through more infrastructure investments. However, the control of local governments' leverage may also constrain their investment capacity.

In Korea, we expect housing market sentiment to stay intact over the next 12 months while possible uncertainties could affect the near-term outlook. Despite continued housing price growth, we believe the government's property market measures, tightened debt financing, and potential policy changes related to the upcoming presidential election in March 2022 have created uncertainties. Overall, we expect housing construction volumes to show a slight increase in 2022 compared with 2021. Also, rapid raw material price hikes will provide opportunities for building material companies to raise its product prices. The prolonged pandemic situations and social distancing measures would partly boost replacement demand for home remodeling and alterations for building materials. Meanwhile, we anticipate the government-led major housing supply projects, including the third-phase Newtown project, will also be helpful for building materials companies' business to business sales in the midterm. We see further upsides in housing supply because the government aims to increase nationwide housing supply in the long run.

Credit metrics and financial policy

We forecast credit metrics of our rated companies to remain largely stable in 2022 versus 2021. Revenue growth in 2022 will be offset by weaker profitability on higher costs. Financial policy will remain disciplined. Capex will be stable year over year in 2022 because there will be no significant expansions or acquisitions. We also do not foresee demand for higher dividends. Overall, our rated universe's credit metrics should sit comfortably within their respective rating range.

Key risks or opportunities around the baseline

1. Weakness in demand and rising costs are key risks

Slower-than-expected economic growth or a more severe impact than expected on construction activities due to the pandemic is the key risk for demand in 2022. Rising costs due to input materials and labor will hit the companies' profitability if they cannot be fully passed through to customers.

2. Large players to gain from industry consolidation, in particular China

Industry consolidation of China's cement industry will likely benefit the leading players because they have the financial strengths to be the consolidators. As China continues to tighten its environmental regulations, the industry leaders are also the ones that will be able to meet the new requirements by investing in new technologies. Smaller players will likely be either acquired or phased out.

3. Carbon trading will benefit players with lower emissions

Although APAC generally lags Europe in carbon trading, it is likely that more and more countries will introduce their own emission trading systems. The impact on the sector depends on the design of the scheme and the price of carbon. Yet our rated entities are generally the industry leaders that have fewer emissions than the industry average. They should fare relatively better than peers when a carbon tax is rolled out.

More adverse developments of the pandemic and the potential rise of U.S. interest rates could dampen demand in 2022. The property sector is more sensitive to interest rate hikes while infrastructure investments rely more on government policies. Depending on governments' tolerance for economic slowdown, the increase in infrastructure investment may offset weaker property investment but that will strain governments' financing resources.

A weaker economic outlook will probably limit the magnitude of cost increases. Yet this will likely hit volume and pricing, thereby leading to weaker profitability and credit metrics.

China's cement industry has been in over-capacity for years. However, Chinese cement companies have been optimizing their production in order to maintain their respective utilization rate and profitability. As China continues to consolidate its cement industry, the leading companies, which are usually state-owned, are more likely to be the consolidator given their strong balance sheets. This will further expand their market share and solidify their market positions.

China's national carbon trading scheme was launched in July 2021 and currently covers only power producers. The government does plan to expand to cover other heavy emission industries like building materials, steel, and petrochemicals. The impact on cement producers remains to be seen, depending on how the government allocates carbon quotas and the price of carbon, currently at about 10% of that in Europe.

Whether carbon quotas are allocated free of charge, like power producers, or at a cost, we believe our rated companies stand at a better position compared with their peers because their emissions are below the national average. Therefore, they are the ones more likely to benefit from the introduction of carbon pricing because those that cannot meet national standards will likely shut down or sell themselves to stronger players who can meet the standards.

Industry forecasts

Global Building Materials

Chart 16

Revenue growth (local currency)

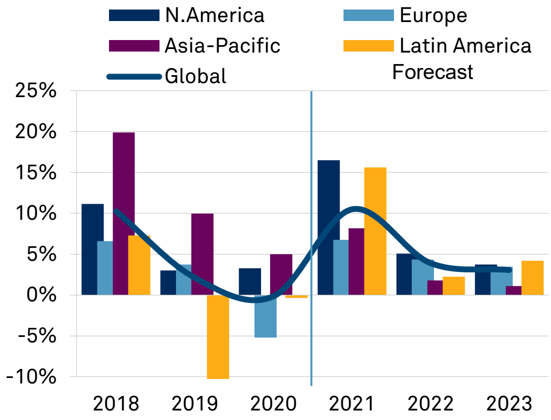


Chart 17

EBITDA margin (adjusted)

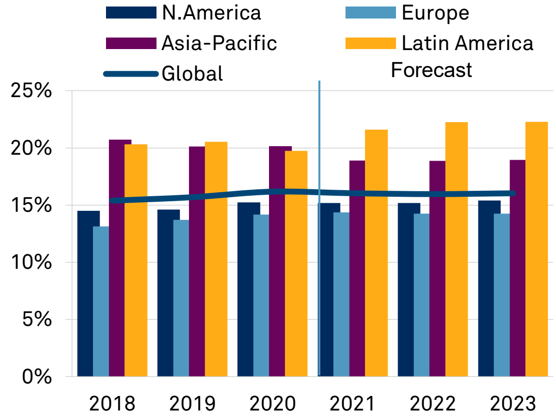


Chart 18

Debt / EBITDA (median, adjusted)

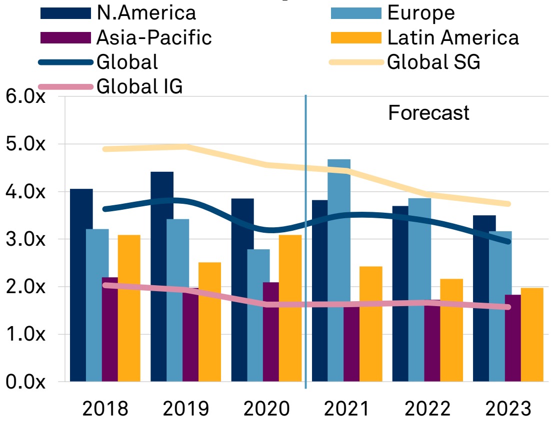
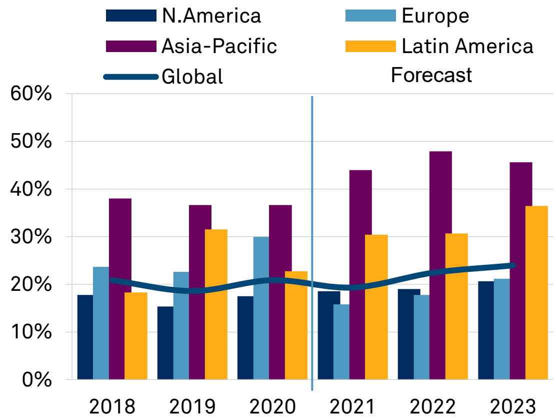


Chart 19

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. 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

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Chart 20

Cash flow and primary uses

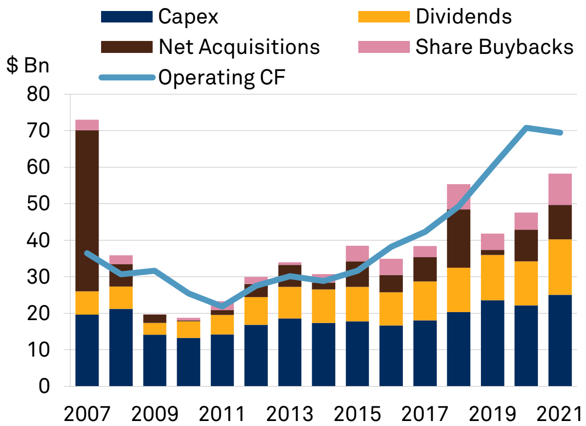


Chart 21

Return on capital employed

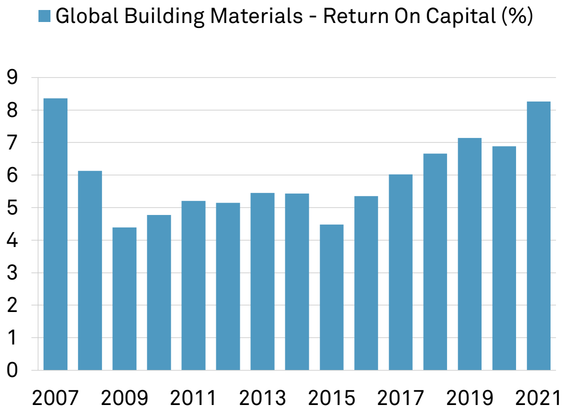


Chart 22

Fixed versus variable rate exposure

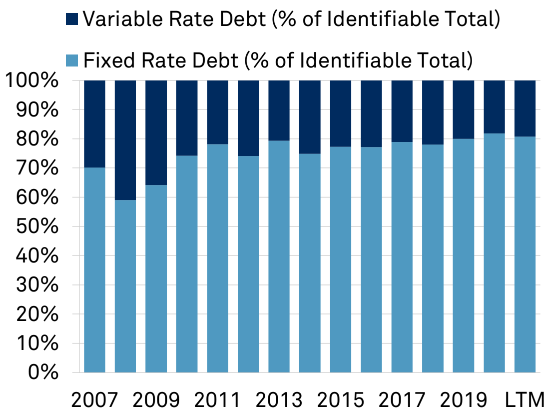


Chart 23

Long term debt term structure

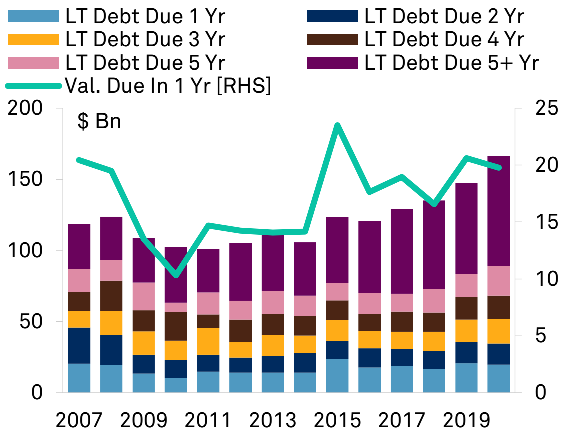


Chart 24

Cash and equivalents / Total assets

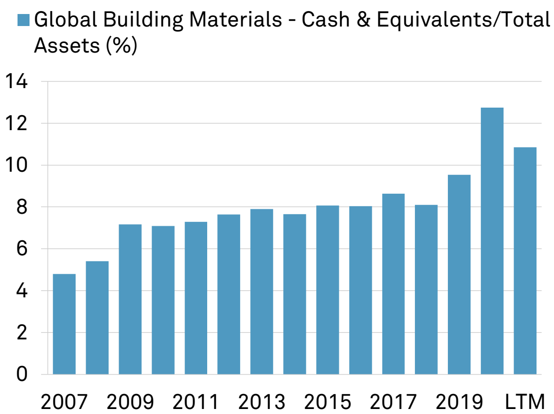
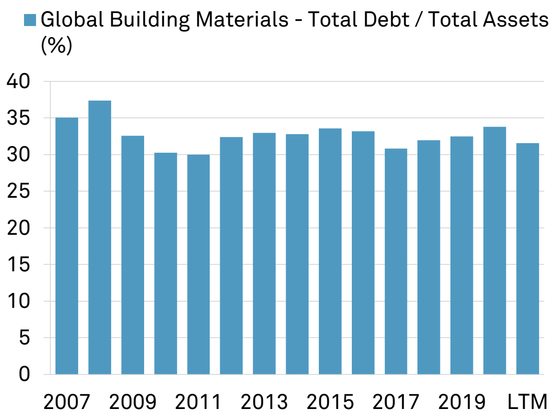


Chart 25

Total debt / Total assets



Source: S&P Global Market Intelligence, S&P Global Ratings calculations. Most recent (2021) figures are using last twelve months (LTM) data.

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