

CEMEX

In 1906, the year Cemex (CX) was founded, it produced about 30,000 metric tons of cement at its lone facility in northern Mexico. For 2008, it expects to produce over 96 million metric tons of cement, 80 million cubic meters of ready-mix concrete and 222 million metric tons of aggregates. As the world's third largest concrete producer by sales (over \$21 billion in revenues in 2008), Cemex maintains production facilities in more than 50 countries. Over the last 100 years, a strategy of acquisition, as well as a focus on reducing costs, has transformed Cemex into a key player in the world cement business.

Cement and concrete are clearly commodities—one brand is nearly as good as the next—so buyers typically make decisions based primarily on price. In light of this fact, it may not be easy to see how one company could establish a competitive advantage over its peers. However, the low-to-mid-double-digit net profit margins achieved by Cemex suggest one exists. Although it's not obvious, a main barrier to competitive entry and source of competitive advantage is Cemex's rock quarries. The rock and gravel used in production and the final product itself are not easy to transport, so having a quarry near your customers is a huge plus. In fact, Cemex operates more than 560 quarries strategically located around the world. Wherever it enjoys this regional advantage, the result is lower overall logistics costs than most competitors and higher profit margins, despite operating near competitors' prices. It also helps Cemex to keep a tight lid on production costs and to run its logistics segment as efficiently as possible—areas where it excels. Cemex has replicated this basic, powerful business model on a global scale with great success.

However, the path from producing 30,000 tons of cement annually to nearly 100 million tons has hardly been a straight line. The demand for its products is extremely cyclical, and Cemex must continue to cover the costs of operating massive logistics and quarries networks whether global construction is expanding or contracting. With this in mind, 2008 was a year to forget for Cemex. After acquiring the U.S. assets of rival Rinker in late 2007 (financed mostly with debt), the U.S. housing market experienced an incredible contraction. In fact, most of the newly acquired assets are located in some of the hardest hit areas of the domestic housing market: California, Florida and Arizona. When you combine this with housing recessions in other key markets such as Spain and the U.K. and delays in Mexico's planned infrastructure builds, operations suffered significantly. Historically, the company has generated tremendous cash flow, and it had projected that cash from operations would pay down all debt due in the next couple of years. But with business suffering, perhaps only half of its obligations will be covered, necessitating asset sales and refinancing of existing debt. Of course,

that's not easy to do in an environment of depressed asset prices and very tight credit. Recently though, Cemex announced that its creditors agreed to an extension of some current loans, along with several favorable changes to debt covenants. Cemex has also completed a handful of asset sales in 2008, using the proceeds to reduce debt. Add to these issues recent problems in managing Cemex's currency exposure and the Venezuelan government's decision to nationalize the cement industry in Venezuela (including a small portion of Cemex's assets), and it's easy to see why some investors abandoned the company in 2008.

But even as global construction continues to flag, we think there is plenty to like here. Cemex is well positioned to benefit from continued demand for infrastructure-related building worldwide. Much of the world's emerging middle class needs housing, sewage and water systems, power plants and factories. Many infrastructure facilities in the industrialized world have been neglected and will likely be updated. We find Cemex's facilities attractive, given their proximity to where these needs seem to be greatest. And we believe that successful price increases recently put in place in key markets are evidence that its competitive advantage remains intact. Also, despite the risks created by the Rinker acquisition, CEO Lorenzo Zambrano and his team have proven to be successful acquirers under a variety of challenging conditions. We also like it when managers are heavily invested alongside shareholders, and Zambrano's leadership team and their families own over 10% of the company's shares. To be sure, risks have emerged for Cemex at this time, but there is also significant upside potential.

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