China Cement Sector

DBS Group Research . Equity 7 June 2022

Is market too optimistic on 2H recovery?

- **Cutting our 2022 cement consumption forecast from -1% to -5% per our base case to reflect worse-than-expected slowdown in property constructions**
- **Market may have overestimated the support that infrastructure sector can bring in 2H22**
- **Slash FY22F/FY23F earnings by 13-16% for the cement names we cover on lower sales assumptions**
- **Cut TP upon benchmarking trough cycle multiples; downgrade CR Cement to SELL, Conch and West Cement to HOLD, but BUY CNBM's non-cement prospect**

Boost in infrastructure spending will likely be insufficient to cover shortfalls from the property downturn. Our scenario analysis indicates that cement consumption from property will likely fall by 16% to 38% in 2022 after factoring in both the decline in GFA new starts and lengthened construction cycles. In our base case, where cement demand from property will fall by c.24%, infrastructure spending growth will have to pick up from the current 6.5% in 4M22 to >20% for the remainder of 2022 to offset the shortfall, a relatively stretched magnitude to reach. However, this does not incorporate the likelihood that some of the spending may be directed to "new infrastructure" projects, which may consume less cement vs. typical road and bridge constructions. We believe the market's current expectation that cement consumption will rebound in 2H22 looks overoptimistic. We cut our 2022F cement consumption forecast from a 1% drop to a larger 5% decline.

Cement unit prices and margins under pressure. Cement producers have been cutting their cement production volumes. However, such reductions will likely be insufficient to fully offset the demand shortfall, per our estimation. Additionally, cement's inventory level has continued to build up from c.61% at the start of 2022 to above historical normal range at >70% full of the warehouses by May 22.

Cautious on cement players but like CNBM's non cement prospect. Benchmarking their respective trough cycle P/BV valuation targets, we downgrade CRC to SELL, and Conch and West Cement to HOLD. Considering CNBM's TP still offer >15% share price return, we have maintained a BUY on CNBM and it being our sector top pick.

HSI: 21,654

ANALYST
Duncan Chan +852 36684178 duncanchan@dbs.com
Danielle Wang +852 36684176 danielle_wang@dbs.com
Ken He +86 21 38562898 ken_he@dbs.com
Jason Lam +852 36684179 jasonlamch@dbs.com
Zoe Zhang +86 21 38562892 zoezhangbb@dbs.com
Dexter Chun dexterchun@dbs.com
Ben WONG benwongkf@dbs.com

Recommendation & valuation

Company	Currency	Price	Target Price	Rating
Anhui Conch Cement (914 HK)	HK$	32.7	36	HOLD
Anhui Conch Cement-A (600585 CH)	RMB	35.21	39	HOLD
China National Building Material (3323 HK)	HK$	7.94	11	BUY
China Resources Cement (1313 HK)	HK$	5.71	5	SELL
West China Cement (2233 HK)	HK$	1.02	1.1	HOLD

Source: Thomson Reuters, DBS Bank (Hong Kong) Limited ("DBS HK")

Cement consumption to take a toll due to slower-than-expected property construction activities

China property sector a core pillar that impacts cement consumption levels. While the China property sector's cement consumption has been on a declining trend throughout the past decade, the sector has continued to serve as a core pillar that contributes >30% of total annual cement consumption in China.

Consumption of cement is typically done in phases according to the progress of the construction in question. A sizeable part of the cement (typically c.30% of the total to be consumed in a project) would often be ordered at the start of construction, whereas the remainder will be consumed according to the construction schedule. We, therefore, place our core focus on the China property sector's impact on the cement sector in terms of 1) real estate investment; 2) GFA new starts; and 3) expected completion cycle.

Significant decline in real estate investments may extend into 2H22. Alongside the China property sector's ongoing liquidity crunch, real estate investment in China remained on a decelerating trend and headed into a decline in 4M22, at -3%, in part as a result of 1) muted activities on the land acquisition front; and 2) delayed new starts (-28% y-o-y in 4M22) and prolonged construction processes (GFA completed fell 11% y-o-y in 4M22), among others. We estimate such slowdowns would have translated into a c.24% decline in cement consumption from the property sector to date. As dust in the property sector will likely take longer to settle due to complexities stemming from the COVID-19 lockdown measures, China's macroeconomic outlook uncertainty, as well as geopolitics, the physical property market will likely remain on the decline, albeit a lower comparison base in 2H22, with residential ASP to fall 0-5% and GFA to drop 10%-15%.

Residential GFA new starts decline may maintain at 4M22's level for the full year. Residential GFA new starts fell 44% in Apr 22, which dragged the YTD new start decline to 28%. We expect residential GFA new starts to remain subdued for the rest of the year before the liquidity crunch in the property sector is addressed, even though the physical market may start to show signs of improvement in 2H22.

Project completions could see some delays as well. With a rising number of developers heading into financial difficulties, an increasing number of projects under development have also witnessed delays and temporary halts in construction as developers opt to conserve cash flow. We believe this will likely pose delays to the average duration of project completions as well, a phase that contributes c.70% of the total cement consumed during a project development cycle. This will therefore pose further downward pressure on cement consumption in 2022.

Cement demand from property could be slashed by 38% in 2022 under our pessimistic case. Our scenario analysis captures contributing factors both from a likely prolonged decline in construction new starts and lengthened development cycles (factoring a project completion horizon of 1.8, 2.0 and 2.5 years from the commencement of construction). Our analysis result shows that cement demand from the property sector could decline at a rate between 16%-38% in 2022.

Scenario analysis of cement consumption demand from the China property sector

	Bear case	Base case	Bull Case
Assumed project completion cycle (yrs)	2.5	2.0	1.8
Cement consumption decline from ppty (%)	-38%	-24%	-16%

Source: DBS HK

Acceleration in infrastructure projects will be insufficient to fully offset the shortfall

Infrastructure investment to take the driving seat for economic growth in 2022. As reiterated by the central government during numerous high-level meetings including the recently hosted State Council executive meeting, CCP politburo meeting, and a teleconference on implementing policies to stabilise the economy, efforts must be made to keep the Chinese economy running within an appropriate range, including fast-tracking infrastructure projects. This, alongside a loose monetary environment and accelerated pace in special bond issuances and infrastructure REITs, will likely offer a meaningful boost to infrastructure spending in the upcoming two quarters, in contrast to the subdued average infrastructure investment growth rate of <2% from 2018-2021.

FY22 infrastructure spending growth to range between 7%-12%. We took reference from the infrastructure investment growth range of 14%-21% during the "golden age" of the China infrastructure sector in 2012-2017 for infrastructure spending growth in the upcoming months. We estimate that full-year infrastructure spending growth could range from 6.5% in our bear case, where no acceleration will be seen from the current level, to 11.5%, where spending growth for the remaining months would pick up to 14% – equivalent to the floor range of the "golden age".

Increment from infrastructure spending will be insufficient to offset shortfall from the property sector. Coupling this with our above-mentioned scenario test results, we estimate, in our base case, where cement consumption from the property sector declines by 24%, **infrastructure spending will have to increase by 18.5% to generate cement consumption demand that can fully offset the shortfall** – a highly optimistic figure, as it will **translate into an infrastructure spending increment of 22% for the remaining months**. We, therefore, believe the market's current expectation of a 0-5% growth in cement consumption for 2022, alongside support from an infrastructure boost, may have been overoptimistic.

Scenario analysis of overall cement consumption demand

	Bear case	Base case	Bull Case
Assumed project completion cycle (yrs)	2.5	2.0	1.8
Expected infra. spending growth	7%	9%	12%
Cement consumption decline from ppty sector (%)	-38%	-24%	-16%
Total cement consumption growth/decline (%)	-13%	-5%	0%

Source: DBS HK

With our scenario test results in mind, we are revising down our 2022 China cement consumption forecast from 1% drop to 5% decline.

Cement supply reductions in progress, but pace is unable to fully match demand downfall

Suspended cement production to mitigate excess supply. In 1Q22, China's downstream market for cement consumption was weak, dragged, in part, by disruptions led by COVID-19 lockdown measures. As such, cement plants' ex-factory sales have been subdued, and average cement silo has elevated to >60% of factory warehouses' full capacity since Nov 21. Accordingly, cement producers have adopted a kiln capacity suspension and off-peak production arrangement to minimise excess cement supply. As a result, China's cement production fell by 15% y-o-y in 4M22, which marked the largest decline in history.

Shifted from a clinker importer to a net exporter, but actual impact remains insignificant. China has net exports of 440k tonnes of cement and clinker products in 4M22, as compared to net imports of 1.84m tonnes in 4M21. While net exports remain insignificant as compared to total apparent consumption during the respective periods, the change in direction may hint at a shift in producers' strategy to pursue export opportunities amid sluggish local market sentiments, as well as the incentive to take advantage of the higher price overseas currently vs. the local market. Having said that, given the insignificant amount involved, the role that this trend would play in the near term would be limited.

More supply reductions on the way. Since May 22, cement producers have initiated additional plans (e.g., Shandong and Shanxi having extra days of production suspension during summer) to reduce production plant utilisations alongside the market's expectation of lacklustre demand. While cement supply has witnessed record-high levels of decline in 4M22, we believe this may not yet be sufficient to fully match the expected demand downfall in the coming months. As such, we believe cement supply will likely fall further in the upcoming months, and a supply-demand equilibrium may only be reached as early as 3Q22.

Cement price pressure to remain in the near term. Alongside the property sector downfall and disruptions from COVID-19 lockdown measures, the price decline has continued despite that we are entering the traditional construction peak season in May 22. According to data from the China Cement Association, the average price of PO 42.5 grade cement in China had been on a downtrend since Oct 21, from hitting its record high of Rmb626 (tax inclusive) to dropping to an average of Rmb509 per tonne in 5M22. Under the expectation that excess supply will continue in the near term, we believe China cement prices will remain under pressure before a supply-demand equilibrium is reached. We currently expect average cement prices in 2022 to drop 3% y-o-y from 2021's average level to RMB470 per tonne.

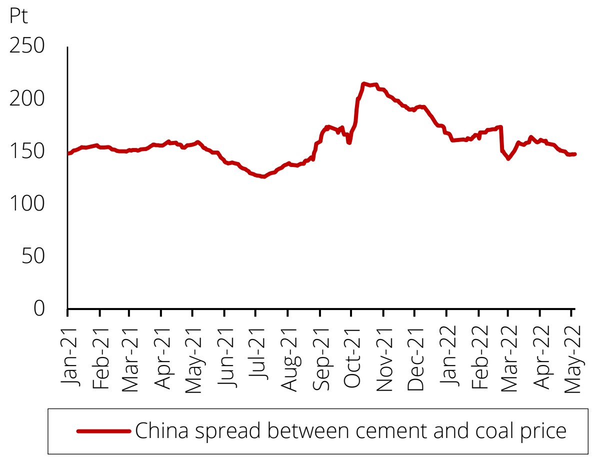
Cement sector outlook – sales volume to stabilise, selling price and GPM may start to smoothen

Full-year cement sales volume to stay in negative territory. 1Q22 results announced by the China cement companies we covered reported a certain level of impact from halted property construction progress in the form of declines in cement sales volumes – from 11% (CNBM) to 32% (CR Cement). Meanwhile, as there have been limited signs of improvement in April and May alongside 1) limited improvements in the property sector and 2) disruptions from COVID-19 lockdowns, we believe companies' managements may opt to revise down their sales guidance during the interim period.

As discussed in the above sections, we do not foresee a significant rebound in residential GFA new starts. Meanwhile, with reference to our scenario analysis, we do not believe the boost in infrastructure spending will be able to fully offset the shortfall from the property sector. While there will likely be a mild pickup in overall cement sales during 2H22, full-year sales will likely remain within the negative territory.

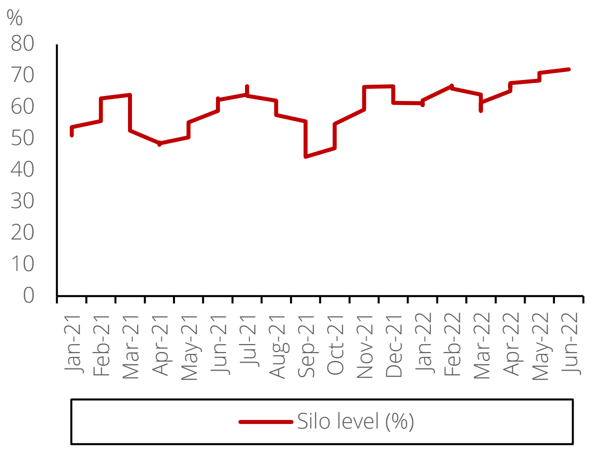
Pressure on gross profit margin to continue. Having suffered from continued inflationary pressure on coal and energy prices (both, in aggregate, represent >40% of cement's total production cost) and fluctuations in cement prices, cement producers we cover have faced different magnitudes of margin compressions. While unit costs for coal saw signs of stabilisation recently, cement prices may continue to see some pressure due to excess cement supply. Accordingly, we believe cement producers will continue to feel downward pressure on GPM in the upcoming months.

China product price spread between cement and coal



Source: Bloomberg Finance L.P., DBS HK

China cement silo level rising to record high



Source: DBS HK

1Q22 operating data for CNBM, Conch, and CRC

	Unit	CNBM	Conch	CRC*	China
Sales volume	m tons	56	58	13	387
% y-o-y	%	-11.2%	-15.9%	-32.6%	-12.1%
ASP	RMB/ton	364	367	435	NA
% y-o-y	%	14.8%	14.3%	20.0%	NA
Unit GP	RMB/ton	61	130	104	NA
$ y-o-y	$	-15	0	-4	NA

** HKD currency denominated*

Source: Bloomberg Finance L.P., DBS HK

Major assumptions change

	Unit	CNBM	Conch	CRC*	WCC
Sales volume					
Prior	m tons	373	325	85	20
New	m tons	354	292	79	19
% y-o-y		-5.1%	-10.2%	-7.3%	-4.9%
ASP					
Prior	RMB/ton	360	371	431	340
New	RMB/ton	351	357	423	335
% y-o-y		-2.5%	-3.8%	-1.9%	-1.5%
Unit GP					
Prior	RMB/ton	96	159	142	95
New	RMB/ton	81	148	128	90
% y-o-y		-15.6%	-6.9%	-9.9%	-5.3%

**HKD currency denominated*

Source: Bloomberg Finance L.P., DBS HK

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DBS Bank (Hong Kong) Limited

13th Floor One Island East, 18 Westlands Road, Quarry Bay, Hong Kong

Tel: (852) 3668-4181, Fax: (852) 2521-1812

DBS Regional Research Offices

HONG KONG
DBS Bank (Hong Kong) Ltd
Contact: Dennis Lam
13th Floor One Island East,
18 Westlands Road, Quarry Bay, Hong Kong
Tel: 852 3668 4181
Fax: 852 2521 1812
e-mail: dbsvhk@dbs.com

SINGAPORE
DBS Bank Ltd
Contact: Paul Yong
12 Marina Boulevard,
Marina Bay Financial Centre Tower 3
Singapore 018982
Tel: 65 6878 8888
e-mail: groupresearch@dbs.com
Company Regn. No. 196800306E

INDONESIA
PT DBS Vickers Sekuritas (Indonesia)
Contact: Maynard Priajaya Arif
DBS Bank Tower
Ciputra World 1, 32/F
Jl. Prof. Dr. Satrio Kav. 3-5
Jakarta 12940, Indonesia
Tel: 62 21 3003 4900
Fax: 6221 3003 4943
e-mail: indonesiaresearch@dbs.com

THAILAND
DBS Vickers Securities (Thailand) Co Ltd
Contact: Chanpen Sirithanarattanakul
989 Siam Piwat Tower Building,
9th, 14th-15th Floor
Rama 1 Road, Pathumwan,
Bangkok Thailand 10330
Tel. 66 2 857 7831
Fax: 66 2 658 1269
e-mail: research@th.dbs.com
Company Regn. No 0105539127012
Securities and Exchange Commission, Thailand