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Third World? Really?

Why the discount in Mexican cement company Cemex might not be justified.

Jonathan Lipow 14 Jul 05 16:20

Over the long run, you cannot beat the stock market by mimicking the portfolios held by the average investor. That is why investment firms like Wellington Asset Management with an approximately 80-year track record of beating market benchmarks place a premium on “going where no man has been before.”

One new, and we at Forum FIE believe promising, investment theme is to focus on the growing number of world-class companies that are domiciled in third world countries. These companies offer investors the opportunity to gain access to advanced technology and superior management at a fraction of what it costs to purchase stakes in their first world rivals.

Today, emerging markets offer a wide variety of firms that qualify as global titans in their respective industries. In the technology hardware sector, for example, Taiwan Semiconductors and South Korea’s Samsung Electronics are clearly world leaders. In aerospace, Brazil’s Embraer dominates the market for short/medium haul commercial aircraft and actually managed to run Germany’s Dornier out of business.

What makes these companies interesting as investments is that the capital markets value them at a fraction of their less impressive first world rivals like Nokia or Hitachi in the case of Samsung; and Bombardier in the case of Embraer.

Are these discount valuations justified? Certainly, mainstream investors seem to think so. Their argument is that while companies like Samsung Electronics and Embraer are clearly superb firms, they operate in countries with substantially more political and economic volatility than their rivals in Canada and Sweden. Hence, they deserve to trade at “bargain basement” prices.

On the face of it, this is a reasonable argument. The problem with it is that the financial discrimination against world class emerging market firms extends to companies that base most of their operations in developed countries. Consider, as an example, Mexico’s Cemex (NYSE: CX) - a world-class firm whose stock market valuation is unjustly penalized due to the firm’s emerging market origins. Cemex is the world’s third largest producer of cement, trailing only France’s Lafarge and Switzerland’s Holcim.

One interesting aspect of the building materials industry is that while markets are highly fragmented into national and even regional sectors due to the high cost of shipping cement, the global industry is increasingly dominated by large players that control vast and far flung empires of stand alone cement mills (in addition to Cemex, Lafarge, and Holcim, the other companies involved in this consolidation trend are Germany’s Heidelburg and Ireland’s CRH).

Why does it make sense for seemingly unrelated businesses all over the globe to amalgamate under a single corporate banner? There are two reasons. The first is that the cement business is knowledge intensive. Cement firms actually spend a lot on research and development. Often, these efforts are dedicated to developing new production processes rather than new products. Now, it is well known that it is difficult to prevent competitors from copying innovations in production technology, hence it only pays off to develop new processes if you are big enough to exploit them on a large scale.

The second reason is that, while cement firms manufacture and market their wares in disparate markets, they have remarkably similar needs for machinery. By forming multi-national alliances, the cement producers enhance their bargaining power over suppliers and hence succeed in lowering their capital costs. A similar logic accounts for the emergence of global retailers such as Carrefour, Tesco, and Walmart.

Now, as the big five cement producers have consolidated the industry, they have evolved into entities that bear little resemblance to their original identities. True, Cemex was once a company that operated exclusively in Mexico. Today, however, Cemex is the second largest cement producer in Europe and the United States, while conducting emerging market operations throughout Latin America, Asia, and even in Egypt.

Overall, it turns out that Switzerland’s Holcim is the cement producer most exposed to the vagaries of the third world, while Cemex is even less exposed than Lafarge. In spite of this, it is Cemex that trades at a discount due to its emerging market “exposure.” Just how large is the discount? Lafarge trades at a PE ratio of 12, while its long term projected rate of earnings growth is 10%. Cemex, on the other hand, trades at a PE ratio of 9, while earnings growth is projected at 15%.

SEC disclosure documents show that, as at the second quarter of 2005, Wellington Management, which manages many funds including the Forum FIE’s International Equity Fund, held a $150 million stake in Cemex.

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