Our Outlook for Basic Materials Stocks

Companies scramble to de-lever in a sour economy.
China to the rescue?

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As the second quarter draws to a close, basic materials companies continue to struggle with the unhappy conditions that have defined the sector since the fall of 2008. Feeble demand, soft pricing, and diminished fixed cost absorption have significantly damped sales and profitability for most firms in the sector. With the near-term demand outlook as cloudy as ever, debt-laden players throughout the industry have scrambled to clean up their over-levered balance sheets.

Indeed, it has been a busy quarter for CFOs throughout the basic materials space. Relatively looser credit conditions in the second quarter afforded many heavily levered firms the opportunity to wriggle their way out of near-term maturity trouble. Big refinancing activities included Dow Chemical DOW ($6 billion), Teck TCK ($4.2 billion), Goodyear GT ($1 billion), and International Paper IP ($1 billion). With global stock markets rebounding off lows, firms have also moved to raise equity capital, through secondary public offerings (e.g., ArcelorMittal MT, Steel Dynamics STLD, and Vulcan Materials VMC) or through private placements, such as the now-aborted share issuance by Rio Tinto RTP to Chinalco.

Companies have also turned to asset sales as a means to raise cash. Dow Chemical raised $2.6 billion from a variety of asset sales. CEMEX CX, struggling under the weight of $15.7 billion in maturities due through 2011, has agreed to sell $2.1 billion in assets around the globe. Meanwhile, companies with relatively healthier balance sheets have moved to raise equity capital in preparation for some discount shopping. Recent share issuances by Cleveland Cliffs CLF and Cameco CCJ were undertaken with an eye to snapping up assets of more heavily levered competitors. Heading into the second half of 2009, we expect to see an increase in asset sales activity, as properties trade hands from the cash poor to cash rich.

Despite immensely challenging operating conditions, the second quarter hasn't been all doom and gloom in the basic materials universe. One bright spot has been China. Surging Chinese commodity purchases have provided a much-needed boost to sagging global demand. Imports of a wide range of raw materials, from copper to polyethylene to iron ore, have soared this year, lending crucial support for prices. In fact, during the second quarter, we've seen spot prices for many commodities rise substantially off first-quarter lows. Copper prices have risen 80% to $2.27 per pound from a low of $1.26 per pound. Ethylene prices are up 42% to about $0.22 per pound from a low of around $0.15 per pound. Meanwhile, Rio Tinto announced it had negotiated 2009 iron ore prices with Japanese and South Korean iron ore producers that amounted to a 33% price cut from record 2008 levels, a more modest reduction than some had anticipated. Not surprisingly, we've seen similar buoyancy in share prices. Shares of ArcelorMittal, Freeport FCX, and Aracruz ARA are among those that have more than doubled off first-quarter lows, thanks largely to the beneficial effects of surging Chinese import volumes.

This, of course, begs the question: Can China sustain its imports at current levels? With few signs of strength coming from the developed world, global demand for raw materials rests ever more on the Middle Kingdom. Indeed, this is China's "Atlas Moment." A big pullback in Chinese imports, if unaccompanied by rising demand in the developed world, would likely push prices (and producer stocks) south in a hurry. If, however, China's appetite for commodities is sustained, prices and shares could have more room to run. For this reason, we believe the question of Chinese demand is the most important near-term macro issue facing the basic materials industry today.

While heartened by the scope of Beijing's ambitious stimulus package, a fiscal outlay complemented by very loose Chinese bank lending in the first quarter (total loan volumes in the quarter exceeded volumes for the whole of 2008), we see a few reasons why current demand could prove to be unsustainable. First, while Chinese commodity inventory data is sketchy at best in most cases, nearly all evidence strongly suggests inventory building in excess of current requirements. Eventually, this excess inventory will need to be drawn down at the expense of import volumes. Second, in many commodities, we're seeing a massive substitution effect, wherein Chinese buyers have turned to suddenly cheap imports at the expense of domestic supplies, which are often of lower quality (e.g., iron ore and pulp) and are now more costly than imported alternatives. We expect Chinese buyers will in many cases return to domestic supply sources should import prices rise much further. In concert with inventory drawdown activity, such a development would have a major impact on import volumes and, by extension, global demand. Finally, it's worth noting that, in many cases, underlying Chinese end goods demand is growing at a much slower pace than imports.

Valuations by Industry

Following the runup in share prices that kicked off in March, most industries in the basic materials sector now appear to be reasonably valued. This stands in stark contrast to our first-quarter valuation snapshot (taken mere days after the market bottomed), when all industries appeared significantly undervalued.

Basic Materials Industry Valuations

Segment	Average Star Rating	Price/Fair Value*	P/FV Three Months Prior	Change (%)	Uncertainty** (%)
Agriculture	3.69	0.87	0.67	29.9	50.0
Building Materials	2.99	0.98	0.63	55.6	33.0
Chemicals	2.65	1.05	0.75	40.0	69.3
Engineering & Construction	3.20	1.02	0.79	29.1	62.5
Metals & Mining	3.06	0.97	0.68	42.6	84.1
Paper & Packaging	2.98	1.17	0.68	72.1	54.5
Steel & Iron	3.14	0.91	0.56	62.5	71.6
Wood Products	3.10	0.75	0.42	78.6	65.9

Data as of 06-12-09.
*Market-Weighted Harmonic Mean
**Ranks the industry's fair value uncertainty (most uncertain =100) based on the aggregate market-weighted uncertainty ratings of all industries under coverage.

On a market-cap-weighted basis, the agriculture and wood products industries continue to be relatively undervalued, although this is largely attributable to the contributions of two large-cap firms: Monsanto MON and Weyerhaeuser WY, both of which are trading at significant discounts to our fair value estimates.

Our Top Basic Materials Picks

We've picked four stocks from our 4- and 5-star lists to keep on your radar screen. Two of our selections are wide-moat agriculture-related firms: Compass Minerals CMP and Monsanto. We've also included our favorite pick from the building materials industry, Vulcan Materials. Reliance Steel and Aluminum RS operates one of the largest metal service centers in the United States.

Top Basic Materials Sector Picks

Company	Star Rating	Fair Value Estimate (USD)	Economic Moat™	Fair Value Uncertainty	Consider Buying (USD)
Compass Minerals International, Inc.	★★★★★	85.00	Wide	Medium	59.50
Monsanto Company	★★★★★	134.00	Wide	Medium	93.80
Reliance Steel and Aluminum	★★★★	58.00	Narrow	High	29.00
Vulcan Materials Company	★★★★★	68.00	Wide	Medium	47.60

Compass Minerals CMP

Compass Minerals is a wide-moat producer of highway deicing salt and sulfate of potash specialty fertilizer and has unique, world-class, low-cost resources. We think the current stock price discounts the lower end of likely outcomes for long-term specialty fertilizer profitability (holding all other factors constant). In contrast, we think many powerful trends should support higher long-term prices and profitability, such as declining arable land per person, changing diets, and biofuel production. On the highway deicing salt side, we think the fundamentals are strong and getting stronger. Supplies in the Great Lakes region are tight assuming normal winter weather, and Compass is a dominant player able to expand low-cost production capacity.

Monsanto Company MON

Monsanto is a wide-moat producer of agricultural seed and associated biotechnology traits. We think that the market is overestimating the effects that falling commodity grain prices could have on the firm. We believe that Monsanto's entrenched position at step one in the global food chain along with the incremental value its products create for growers through reducing their input costs and boosting their yields will ultimately serve to preserve the firm's pricing power—even in the face of falling grain prices.

Reliance Steel and Aluminum **RS**

As a leading U.S. metal service center, Reliance Steel & Aluminum benefits from a secular growth trend as the industry quickly consolidates. The company delivered double-digit growth over the past decade with savvy acquisitions and successful integrations. We think the firm's operational expertise and acquisition discipline enable it to produce above-average growth and return on capital. We consider this company the best of its breed in the highly competitive metal distribution industry.

Vulcan Materials Company **VMC**

Vulcan Materials is a leading provider of aggregates in the United States. In certain markets, the company enjoys oligopoly-like dynamics thanks to a fairly consolidated supplier environment. Given its size and broad geographic coverage, Vulcan also enjoys economies of scale in its truck, rail, and low-cost water distribution network. In the long term, we believe Vulcan's quarries will be an increasingly valuable asset, as we expect supply growth to be constrained given the regulatory challenges for opening new quarries.

Daniel Rohr, CFA, does not own shares in any of the securities mentioned above.