Holcim and Lafarge to revise their $40bn mega-merger talks?

Holcim Ltd: Market Cap (as of 13/03/2015): CHF24.52bn

Lafarge SA: Market Cap (as of 13/03/2015): €18.6bn

Introduction

Back in April 2014 Holcim and Lafarge, the two most prominent players in the global cement industry, agreed to consolidate into LafargeHolcim Group, in a merger of “equals” worth $41.0bn in total. Through consolidation the newly formed corporation hoped to achieve, via $2.5bn in expected synergies, sales of $44.0bn and EBITDA of roughly $8.0bn, improving an already wide customer base in more than 90 countries – goals that would have never been achieved by the two companies separately. The combined company would have a market value exceeding $50bn and a manufacturing capacity of 427m tons per year, which would vastly exceed the 227m ton capacity of current industry leader Anhui Conch.

The current terms will result in Holcim investors holding a 53% stake in LafargeHolcim Group thanks to an all-shares transaction with a 1:1 exchange ratio. Closing was expected for the beginning of 2015, with the group planning to be headquartered in Switzerland and listed in both Zurich and Paris.

The rationale

The deal came after the two companies faced rising energy costs, as well as higher debt levels due to expanding demand in emerging markets - a key area where the advantages of growing urbanization and the strong demand for construction materials could have been exploited, even if the on-site competition of well-positioned players like Cemex and the Chinese Anhui Conch were to be overcome. After the burst of the U.S. housing bubble and the Eurozone crisis both the Swiss-based and the Paris-based player were striving to find measures to trim their debt and cut costs, while maintaining their top-tier position in the cementitious materials market.

Even though the global cement industry is dominated, in terms of sales, by a few big players - Holcim being the largest ($23bn in sales), followed by Lafarge ($21bn), the German HeidelbergCement ($18bn) and the Mexican Cemex ($16bn) - it is still marked by over-capacity, and further concentration can bring remarkable benefits. At the same time, however, the merger was expected to face severe regulatory scrutiny on the basis of potential oligopolistic market creation. Indeed, the deal has been facing scrutiny in at least 15 countries, including emerging markets as distant as Madagascar and Philippines.

The prospective synergies...
The potential benefits of the deal are three-fold: the combined entity’s huge scale, its geographical diversification and its enhanced innovation capability. As mentioned above, the global cement industry has been experiencing severe over-capacity over the years, hence seceding contractor bargaining power to suppliers and customers. The scale of the potential LafargeHolcim giant would allow the company to optimise its supply chain management and significantly improve the logistic and operating side of the business. Furthermore, the industry is quite reliant on business cycles as well as the state of the global economy – any slowdowns in the level of building and investment can lead to significant losses. As a combined entity, the LafargeHolcim Group could spread this risk by creating the most geographically diverse enterprise in the industry. Currently, both firms are strong in European and North American markets (which led to planned divestments in these regions), but Lafarge is also prominent in the Middle East and Africa, while Holcim holds a substantial share of the Latin American market. Lastly, the combined entity is expected to have the largest R&D budget in the industry – a huge potential advantage, given the importance of innovation in a mature and saturated market such as the cement industry.

…and the apparent obstacles?

The transaction has been under severe regulatory scrutiny by the European Commission, both for its value and for the nature of the business, well-known for collusion issues, which led to Lafarge being fined twice in its history. As a result, LafargeHolcim had to dispose $6.9bn of assets for the transaction to be approved, and the companies decided to divest mainly in Europe, where demand is stagnant, selling for example the UK building materials group Tarmac Lafarge UK, while maintaining all of their productive facilities in India, China or US. Before the divestitures, Europe accounted for 30% of the merged group’s revenues, while after the disposals it will account only for around 20%. Indeed, asset sales accounted for roughly 15% of the companies’ 2014 EBITDA. In December 2014 the deal was declared in line with the EU Merger Regulation, as the creation of the world’s largest cement maker has been defined not to be detrimental for competition in the industry.

Apart from regulatory issues, other potential obstacles have risen lately. As a matter of fact, while Holcim’s shares have gone up by 5.3% since the deal was announced, its French rival’s have fallen by 1%. This diverging valuation is only partly because of relative currency movements (the Swiss National Bank’s decision in January to abolish the ceiling on the Swiss franc meant that its value had soared, undoing the carefully devised share exchange ratio underpinning the Holcim-Lafarge deal). Diverging performance has also driven the change in mood among Holcim’s shareholders. In its latest results, the Swiss company unveiled higher sales and improved EBITDA in 2014. At Lafarge, by contrast, both sales and EBITDA fell.

Thomas Schmidheiny, Holcim’s former chairman and biggest shareholder, has recently stated that the industrial logic of the deal is undisputed, but has refused to comment on the price, fuelling possible disputes regarding the terms of the agreement. Indeed, although even under the deal’s original terms Holcim would have paid a small premium to acquire Lafarge, changing the share exchange ratio to one that more accurately reflects each company’s current value is equally problematic, as it would make clear that the deal was a de facto a takeover of Lafarge by Holcim. This could stir political controversy in France, where the government has resisted takeovers of domestic companies by foreign rivals.

No extraordinary shareholder meetings were announced by Holcim yet, but a possible renegotiation of the deal terms seems increasingly likely, given the recent financial performance of the companies as well as the exogenous economic impacts.
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