

Philippines: a clean bill of health

More than a year has passed since President Rodrigo R Duterte took office in the Philippines and the country's cement market continues to see strong growth. However, incumbents face challenges in the form of increasing imports and new entrants. Additional capacity is needed as key players fight to retain their market share.

■ by **Manas Tamotia**, LEK Consulting, Singapore



Republic Cement, a joint-venture between CRH and Aboitiz Equity Ventures, has invested some US\$300m to increase clinker and cement capacity in all of its integrated facilities in Mindanao and Luzon (pictured: the Batangas plant in Luzon)

Despite a contentious political backdrop, the Philippine economy continues to show strong growth, expanding at an annualised rate of 6.9 per cent in the 3Q17. This was higher than consensus expectations by economists and made it one of Asia's best-performing economies, just behind Vietnam but slightly ahead of China. Overall real GDP growth in 2017 is expected to be 6.6 per cent, according to the IMF. The Philippines is projected to be in the top 20-largest economies globally by 2050.

Although some businesses and investors are hesitant given the president's rhetoric (reflected in slightly lower cumulative net FDI inflows in the first eight months of 2017 compared to the year before), most commentators see the Duterte administration as decidedly pro-business. There is also a clear pivot away from the US towards China and Russia with a number of new bilateral agreements recently signed and Chinese companies being encouraged to join major sectors such as telecommunications.

The Philippine macro-economic story also appears sustainable over the longer term, driven by strong demographics, manageable debt levels and infrastructure spending. Nevertheless, some risk still persists from the increasingly protectionist behaviour of the US, frequent weather disturbances and economic fall-out from Duterte's politics, exemplified by the EU's warning over the loss of duty-free goods privileges, unless the current human rights record improves.

Build Build Build

The government has a 10-point economic plan, nicknamed Dutertenomics, which includes a massive US\$180bn infrastructure programme called 'Build Build Build'. The programme aims to push spending on building projects to seven per cent of GDP, up from five per cent in 2017. This "golden age of infrastructure" is expected to be supported by projects such as the Mega Manila Subway, Mindanao Railway, along with various other airports, bridges, highways and transportation systems. The president has received US\$9bn worth of pledges in development assistance and private investment from Japan, as well as US\$12bn worth of infrastructure financing deals with Chinese companies.

Increasing cement demand

Following a decade-or-so of stagnant demand for cement in the post-Asian Financial Crisis (AFC) era, the last 10 years have seen continuously increasing demand for cement, growing from around 15Mt in 2010 to approximately 26Mt in 2016 (see Figure 1). However, on a per capita basis, consumption is still relatively low at 250kg versus around 600kg in Vietnam and Malaysia, and 400kg in Thailand, highlighting the long-term growth potential in the sector.

The consensus demand growth outlook for the next five years is in the range of 7-10 per cent each year with some estimates as high as 12 per cent. The 2017 growth rate is expected to be somewhat slower as the planned infrastructure projects have yet to materialise. Nonetheless, the high-growth outlook is primarily driven by infrastructure, which currently accounts for around a quarter of demand. This is expected to increase to around 35 per cent by 2021, seeing a CAGR of 12-14 per cent. The residential market, which currently represents around half of cement consumption, and non-residential sector

The Philippines is no longer "the sick man of ASEAN" as the country is set to initiate substantial infrastructure plans



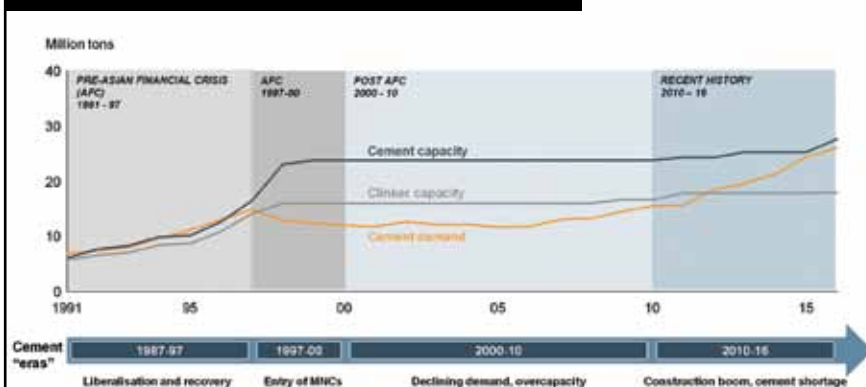
LafargeHolcim currently holds around 30 per cent of domestic grinding capacity and is mainly comprised of old Holcim assets such as the Lugait plant, Misamis Oriental



The residential market, which represents half of cement demand, is forecast to grow 6.7 per cent annually in the next four years



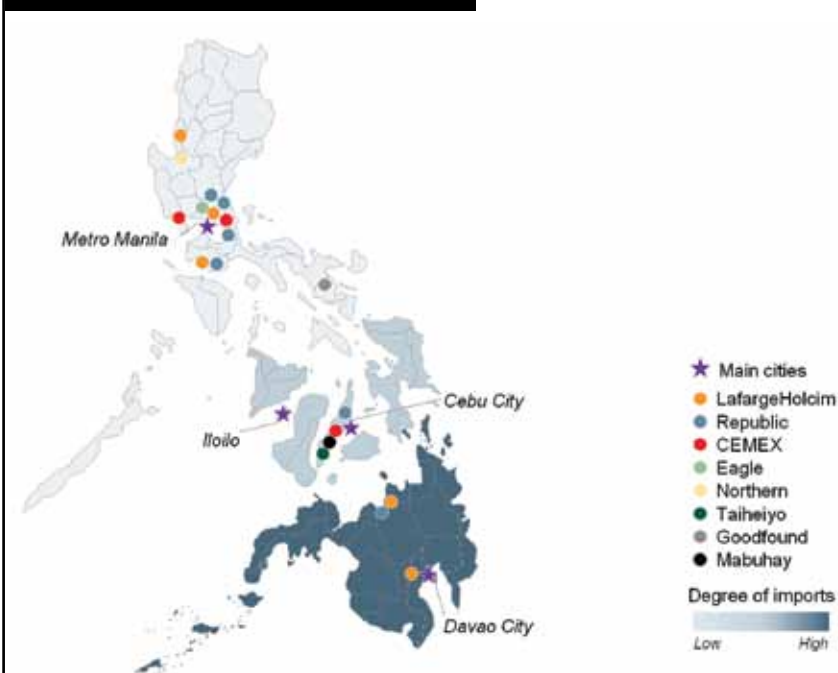
Figure 1: Philippine cement demand and supply, 1991-2016



Note: clinker and cement capacity calculated as 0.85x and 0.9x of installed capacity, respectively

Source: LEK research and analysis

Figure 2: the Philippine cement production base



Source: CemNet, company websites

are expected to grow in the 6-7 per cent per year range.

Islands of limestone

The Philippine islands are endowed with abundant limestone resources with over 30bnt of reserves allowing for an estimated lifetime of over 1000 years. The Philippines primarily uses blended cement (Type 1P is the most common), which has a lower clinker intensity than ordinary Portland cement (OPC).

Substantial local cement capacity was built in the 1990s ahead of the AFC but

has been relatively stable since, with only a few recent additions. In response to the rapid and sustained demand growth, many current and new manufacturers have announced both clinker and cement capacity additions. Three new players have also announced entry into the Philippine cement market. Timing and feasibility of the new capacity additions remain highly uncertain, especially in an uncertain regulatory environment where receipt of key permits such as mining and construction permits can take much longer than anticipated.

Evolving supplier landscape

There are four large players in the country – LafargeHolcim, Republic Cement, Cemex and Eagle Cement (see Figure 2). Together, these players control about 85-90 per cent of the total current cement capacity.

LafargeHolcim currently holds a 30 per cent share of total cement grinding capacity in the Philippines and is largely comprised of old Holcim assets in the country. The company has announced further expansion plans to raise its production capacity from its current 10Mta to 12Mta.

Republic Cement, owned by CRH and Aboitiz Equity Ventures, is largely made up of ex-Lafarge assets sold by LafargeHolcim to avoid anti-trust issues and holds a cement grinding capacity share of around 25 per cent. The company is investing US\$300m to increase clinker production and milling capacity of all its integrated plants in Luzon and Mindanao, increasing its cement capacity by 3Mta.

Cemex currently holds around a 20 per cent grinding capacity share and held an initial public offering (IPO) in mid-2016, one of the largest conducted on the Philippine Stock Exchange. The company's expansion plans include the addition of a 1.5Mta integrated line in Luzon.

Eagle Cement similarly held its IPO in mid-2017 and has announced aggressive expansion plans to nearly double its production capacity to over 9Mta by 2020.

Other players in the market include Taiheiyo Cement Philippines, Northern Cement, Mabuhay Filcement and Goodfound Cement Corp. Several new players such as Big Boss Cement, Century Peak Corp and DMCI Holdings have also announced plans to enter the Philippine cement market.

Increasing imports

As a result of old plants, slow new-build relative to demand growth and excess capacity in neighbouring countries over the last few years, imported cement has grown to around 15 per cent of total consumption with a further approximately 15 per cent from imported clinker. About half of all imports are from Vietnam. Excess cement production capacity in neighbouring countries and the tight domestic supply-demand balance is expected to persist until much of the planned new capacity is commissioned.

Compared to other ASEAN countries, the Philippines does not protect local

cement manufacturing through import restrictions or rules. Until recently, quality testing procedures created a 10-30 day delay for imports, but testing is now allowed in the exporting country. Such preshipment inspections for cement are not common in Asia and have raised imported product quality concerns in the Philippines. Imports from Vietnam could also feasibly increase from 2019 when a five per cent export tariff on cement is expected to be removed by the Vietnamese government. The tariff was introduced in 2015 to disincentivise already-high exports seen to be exploiting local natural resources. However, given regional oversupply and competition from China, the Ministry of Planning and Investment of Vietnam has proposed removing the export tariff.

At an average of around US\$50/t, the cement production cost in the Philippines is also higher than in neighbouring countries. Energy costs are a major factor with electricity and coal together accounting for half of production costs and are relatively high in the Philippines. Industrial electricity rates can be as much as US\$0.11/kWh compared to US\$0.07/kWh in Vietnam. Similarly coal prices are typically elevated in the Philippines as most coal is imported.

Higher cost reduces environmental impact

As a result of increased costs, cement manufacturers in the Philippines have learned to be more energy efficient than their global peers, leading to better environmental outcomes. CO₂ emissions per tonne have been falling by around two per cent each year over the last decade and power consumption per tonne at almost three per cent a year. Use of alternative and mixed fuels for cement production grew more than six-fold (on a per tonne of cement production basis) between 2011-14.

The share of thermal energy production from fossil fuels in the Philippines stood at 77 per cent in 2014 versus a world average of 84 per cent, according to the Cement Sustainability Initiative, and power consumption per tonne is almost 10 per cent lower than the world average. Overall, 10kg less of CO₂ are emitted per tonne of Philippines cement production than the world average.

Market dynamics differ by region

Luzon has historically been the major

cement consumer in the Philippines, accounting for around 65 per cent of demand. The National Capital Region (NCR) in Luzon, including Manila, is a major hub for construction and infrastructure activity on the island, representing about 18 per cent of total demand. On the other hand, Mindanao accounts for 20 per cent of the country's population but less than 15 per cent of cement demand, as a result of its historical political issues.

Due to significant logistics costs in transporting cement, manufacturers tend to dominate regions close to their plants, and normally serve an 80-100km radius of the plant. Therefore, depending on the regional manufacturing footprint of each player, 2-3 players with plants in the proximity tend to enjoy a strong presence in each local market.

In Luzon, Republic Cement, LafargeHolcim and Eagle Cement share approximately 75 per cent of the region's total cement grinding capacity. Conversely, Cemex holds around a 55 per cent capacity share in Visayas with its large Cebu plant and LafargeHolcim has more than 80 per cent share of capacity in Mindanao with multiple plants on the island.

Downstream distribution is still a local game

The users of cement in the country remain highly fragmented. The largest segment, accounting for nearly 75 per cent of cement consumption, is small builders, home owners and contractors buying in 40kg bags from their local hardware retailer.

Given the highly-fragmented nature of the customers and the channels that they buy from, most manufacturers have historically relied on large dealer networks to distribute the product rather than reach each retailer themselves. The dealers will pick up product at the factory gate and then cement travels through a long distribution value chain involving sub-dealers, wholesalers and retailers until it reaches the end user.

Ready-mix contractors are the next largest market segment, accounting for approximately 20 per cent of demand. Transformers (concrete hollow brick makers and large developers) make up the balance of the market. Many such large ready-mix and transformer customers are served directly by the manufacturers and often buy bulk cement.

Pricing

As a consequence of the fragmented

customer base and distribution value chain, there is a significant difference in ex-factory and retail prices, due to distribution costs and margins of various distribution players.

Cement prices vary between the three regions of Luzon, Visayas and Mindanao. Prices in Luzon are the most competitive due to the existence of a large number of manufacturers on the island. The intensity of competition ensures that most players have a strong sales presence, and consequently price awareness amongst the users is high.

On the other hand, prices are higher in some of the islands in Visayas and in Mindanao because of higher logistics costs and often reliance on higher priced imported cement. This is reflected in the disparity of cement retail prices in key cities, such as the NCR (PHP195-210/US\$3.85-4.14/bag), Cebu (PHP170-205/bag), Iloilo (PHP205-230/bag) and Davao (PHP220-240/bag), according to data collected by the Department of Trade & Industry.

Outlook

A number of years have now passed since the Philippines shed its reputation as the "sick man of ASEAN". The economy continues to experience sustained strong growth and cement demand follows. The outlook for the sector is positive, underpinned by substantial infrastructure plans. However, more domestic manufacturing capacity is needed to meet this growing demand. This is a time for incumbents to invest and for the government to support the domestic manufacturing sector to ensure a sustainable and reliable source of cement for the nation's development plans.

Local players should be looking to adopt more sophisticated pricing and distribution practices. In the world of big data, there is clear potential to find efficiency improvements not previously visible, allowing for even more competitive pricing against imports without sacrificing returns. Analytics can also be used to optimise distribution as the country moves toward a greater proportion of bulk over time. Legacy downstream value chains will inevitably continue to evolve as players look for ways to give up less margin whilst maintaining or growing share.

Overall, incumbent players can be optimistic about the future, so long as they are able to grab the opportunity and keep up with the market. ■

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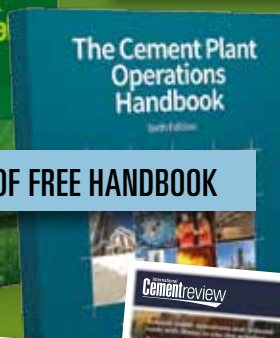
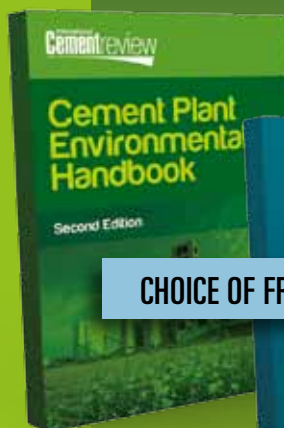


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