

February 19, 2016

Dear clients and colleagues,

High volatility in financial markets is often described as a measure of investor fear. But there are ways to take advantage of volatility. As Warren Buffet said, “Be fearful when others are greedy and greedy when others are fearful.”

Over the last few months, we have accumulated positions in many high-quality companies with defensible business models and strong balance sheets. Thanks to significant volatility and weakness in the market, these companies were trading at a huge discount to their intrinsic value, having been overlooked by short-term investors.

One such company is Eagle Materials (EXP), in which we recently reinitiated a position. We originally bought Eagle in 1H/2012, and later exited the position when its market cap exceeded the upper limit of the MSCI Index. In the current market environment the pendulum has swung in the other direction, bringing EXP back into our investable universe.

Eagle Materials (EXP US - \$57.13)

<http://www.eaglematerials.com/>

Business Description

Headquartered in Dallas, Texas, EXP was founded in 1963 as a subsidiary of Centex Corp. It became a fully independent company through a spin-off transaction in January 2004. In the US, EXP is a leading provider of building materials such as gypsum wallboard (fifth largest), recycled paperboard, cement (twelfth largest), concrete and aggregates.

Target Market

Eagle Materials' products are key components in residential, non-residential and infrastructure construction. For example, Gypsum wallboard is integral to the construction of walls and ceilings in residential and commercial buildings. Cement is the basic binding agent for concrete, which is crucial for highway construction and the development of residential and commercial buildings. In fact, with the exception of water, concrete is the most commonly used material on the planet.

The markets in which EXP operates can be broken down into the following buckets:

- **Aggregates:** \$20B total addressable market (TAM).
- **Cement:** \$9B TAM – There are 98 production facilities in the US, with the top 10 controlling 75% of capacity. Due to cement’s low value-to-weight ratio, land transportation costs are high therefore the industry is fragmented into regional areas.
- **Concrete:** \$30B TAM – Production consumes 75% of cement shipments.

In the US, wallboard production is currently at 22.3BSF, down 40% from 37.2BSF in 2005. Production should increase as the industry expects 1.2M housing starts in 2016, up from 1.1M in 2015. As a reference point, since 1960 the long-term mean for housing starts has been 1.4M.

On the cement side, the recently announced Highway Transportation Bill calls for \$305B in spending on roads, bridges and rail lines over the next five years. According to the Portland Cement Association, the Highway Transportation Bill will, on average, create demand for an additional 835 thousand metric tons of cement per year. On the supply side, the US Environmental Protection Agency's new guidelines for cement production are not economically feasible for some, which may lead to higher prices or reduced production capacity in the industry.

Eagle Material's Competitive Advantages

- Low-cost producer.
- Cement has a high barrier to entry due to its capital-intensive nature and strict environmental regulations.
- A wallboard plant takes 3 years to come online, and most players are closing facilities.

Growth Strategy

- Organic through increased distribution and price increases. EXP was the first to increase wallboard prices in 2012.
- M&A – Strong balance sheet allows EXP to buy existing manufacturing plants from struggling competitors at below replacement cost.

Management

- Insiders own ~\$40M of the company.
- CEO Steven Rowley started as a plant manager in 1991 and became CEO in 2003. He will retire on March 31, 2016. The incoming CEO, Dave Powers, has been with the company since 2005.

Risks

- Competitive market.
- Dependent on public sector spending in some markets.
- Texas accounts for 20% of cement sales in the US.

Market Data

Market Cap: \$2.7B, P/E (2017): 13.7x, EV/EBITDA (2017): 7.8x, Dividend Yield: 0.7%.

Have a good weekend.

The Global Alpha Team