Investing in the Materials Sector: The Less Basic, the Better

MATERIALS SECTOR REPORT

Companies mentioned in this report:

Buy-rated:

- **Corteva** (CTVA - $57.17)
- **Ecolab** (ECL - $227.45)
- **FMC Corp** (FMC - $60.34)
- **Linde Plc** (LIN - $461.34)
- **Nutrien** (NTR - $54.60)

Hold-rated:

- **BHP Group** (BHP - $59.17)
- **Dow Inc.** (DOW - $59.29)
- **DuPont** (DD - $76.83)
- **Sherwin-Williams** (SHW- $333.96)

Prices and opinion ratings are as of market close on 4/2/24 and subject to change. Source: Reuters.

For more information:

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The less basic, the better – Given the large number of basic chemical and commodity companies that exist in the materials sector, many investors refer to the sector simply as "basic materials." While fair to some extent, we believe there are also some differentiated businesses that offer long-term investors favorable growth opportunities.

Be selective; look at competitive advantages – We believe that investors should be selective when investing in the materials sector. Our outlook on the different end-markets varies significantly. However, the common theme among the stocks we like is that we believe the companies all have some type of competitive advantage that should enable them to perform well in varying environments.

Finding investment candidates: While its overall portfolio weighting is relatively small, the materials sector comprises a diverse array of metals and mining, chemicals, and agriculture companies. We suggest gaining exposure to this cyclical, more volatile sector, considering the price movement level of each stock.

Within chemicals, focus on specialized firms – Specialized chemical companies tend to experience more stable demand that is less impacted by economic weakness, potentially leading to financial performance that is less cyclical with better long-term growth. Our current Buy-rated stocks in specialty chemicals include FMC Corp, a maker of a variety of crop protection chemicals including herbicides, fungicides, and insecticides as well as industrial gas provider Linde.

Agriculture outlook supported by key trends – We like companies focused on the agriculture market, as they should likely benefit from increased food production and changes to the diet of emerging-market consumers. We also have positive outlooks for specialty agricultural-chemical companies that operate in attractive niches that allow them to have above-average growth prospects and stability. Grain prices have recovered to well above pre-pandemic levels, which provides a favorable backdrop for agriculture-industry players currently, in our view.

Near-term growth could be pressured by rising rates - The materials sector is sensitive to general economic activity. In 2023, earnings growth in the sector could be pressured by central-bank interest-rate increases, which aim to slow economic growth in order to cool inflation. We believe this underscores the importance of focusing on differentiated companies that can generate growth in varying environments.

Analyst: Faisal Hersi, CFA

Please see important disclosures and analyst certification on page 5 of the report.

The less basic, the better - Given the large number of basic chemical and commodity companies that exist in the materials sector, many investors refer to the sector simply as "basic materials." Most of the companies in this sector rely solely on higher commodity prices to improve their earnings. Due to the commodity nature of their products, materials companies are generally viewed as lower-quality investments. However, as with every sector, the materials sector contains some companies with attractive competitive advantages. Our focus on both the long-term trends that drive earnings growth and on business models with competitive advantages leads us to some quality companies. Therefore, while the "basic materials" label is fair to some extent, we believe there are also some differentiated businesses that offer long-term investors favorable growth opportunities.

Even with our focus on quality, the material companies in this report are affected by economic cycles and the cyclical nature of the prices of their specific materials. Therefore, during periods of sustained weak commodity prices, producers' earnings can be impacted significantly.

Be selective; look at competitive advantages – We believe that investors should be selective when investing in the materials sector. As detailed below, our outlook on the different end-markets varies significantly. The common theme among the stocks we like is competitive advantage. We believe in companies with the competitive advantages needed to perform well in varying environments. Below we talk about the trends that we think will endure and point out how the companies that we cover will be influenced by those trends.

Agriculture outlook supported by key trends – The agriculture market is likely to be the beneficiary of a couple of long-term trends. First, as global population increases, food production needs to increase to feed everyone. One way to increase food production is to increase crop yield per acre. Several of our companies provide the fertilizers, seed traits, and crop protection products such as herbicides, fungicides and insecticides that are needed on a modern farm to achieve and protect higher yields. Without fertilizers, we would need substantially more farmland to grow the same amount of food that we now produce, and with each crop, essential plant nutrients like potash, nitrogen and phosphate are constantly being removed from the soil, and therefore need to be replenished.

With global population expected to reach 9 billion by 2050, the Agriculture Organization of the United Nations estimates that more than a 70% increase in overall food production will be required to feed the additional people[1]. A large part of the increased food consumption is projected to come from a change in diet as incomes rise in emerging markets, with more meat and high-quality fruits and vegetables becoming an integral part of the diet at higher disposable incomes. The combination of a larger, more affluent population creates an attractive opportunity for any company with the innovative products that can either increase or protect yield, in our view.

Second, U.S. farms will likely get much bigger over the next 10 years. According to the USDA Census of Agriculture, the average age of the principal operator of a U.S. farm is 58 years old[2]. Farmers as a labor group have one of the highest average ages of any occupation in the U.S. These demographics mean that over the next 10 years probably 50% of all the farms in the U.S. will change ownership. The changes that result from this turnover mean that fewer and bigger farms will remain, operated by a younger, more tech-savvy group of farmers or managers. If those larger farms look something like the big farms currently, they will likely use more customized products and have more money to invest in higher yields.

Who benefits from these trends? Through its retail farm stores, Nutrien envisions helping farmers produce higher yields by monitoring crop, soil and yield conditions in a way that maps each individual field. Better mapping should lead to better measurement and application of crop inputs, maximizing plant uptake, and minimizing waste. The result should be better yields and less environmental destruction. Corteva is a provider of the precision farming technologies that helps farmers and their advisors develop more informed decisions to get the most from their fields.

Within chemicals, focus on specialized firms – The chemical industry is large and diverse, with differing growth outlooks for the various end-markets. Some companies are primarily basic chemical companies, such as plastics, and their financial performance tends to rise and fall with the health of the economy. The basic chemical companies have modest long-term growth rates. Other companies are almost exclusively specialty chemical companies. Specialized chemical companies tend to experience more stable demand that is less impacted by economic weakness, leading to financial performance that is less cyclical with better long-term growth. Thus, we gravitate toward the specialized firms within our chemicals coverage.

For example, we like FMC Corp's strong presence in crop-protection chemicals. We expect this differentiated business to generate sustained above-average revenue and earnings growth. Sometimes, a competitive advantage doesn't come from a unique product lineup but rather from a more efficient business that can provide superior service at a lower cost to its customers, allowing it to drive higher profitability and increase its opportunities to take market share, which we believe to be the case for industrial gas provider Linde.

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Cautious on iron ore, copper and steel-making-coal miners – On the negative side, we believe that the infrastructure build-out in China that characterized the last 20 years has probably peaked, meaning that we are likely past peak demand for many of the base metals. With China being such a large consumer of most raw materials, changes in its construction markets could swamp the effects of higher growth in the U.S. and Europe. As a result, we are very cautious about the mining stocks that provide the basic materials used in China's construction market.

Materials Segments Not Covered by Research:

While Edward Jones research does not currently cover any pure-play companies in the paper and forest products and precious metals subsectors, we offer the following general comments on the group:

Paper and Forest Products
Generally speaking, the paper and forest products subsector is mature, cyclical, and intensely competitive. While the key drivers can vary from company to company depending on product positioning, the primary influencers of the group include housing construction, employment (paper consumption), and consumption of nondurable goods (packaging).

Precious Metals
Intuitively, the more narrowly focused mining firms focused on precious metals will be highly reliant on the price of the gold, silver and platinum they produce While platinum has industrial applications in the automotive industry, gold and silver are primarily considered financial resources instead of raw materials (despite their use in jewelry). Therefore, demand and pricing are heavily influenced by financial market factors such as interest rates, inflation expectations, and changes in risk appetite, rather than traditional economic and end-market dynamics that typically influence commodity prices.

Thermal Coal
Thermal coal has a lower carbon content than steel-making coal and is mainly used for electricity generation. It accounts for a minority of electricity production in the U.S., but China is still reliant on coal for a significant portion of its electricity production. There are large and readily available reserves spread across several continents. Even though thermal coal is expected to remain the main source of affordable energy for emerging-market economies, it faces major challenges that are likely to persist.

In the U.S., shale development has led to an overabundance of natural gas, resulting in falling prices and making natural gas a competitive alternative. Power plants have accelerated the switch from coal to natural gas, driven both by the relative prices and environmental benefits. Bottom line, long-term demand appears unlikely to grow meaningfully as rising electricity demand is offset by the shift to cleaner fuels.

Materials Coverage Summary

FMC Corporation (Buy) - FMC Corporation is a global chemical company that provides crop-protection solutions to the agriculture industry. In light of evolving farmer needs to control pest and week pressures, we have a favorable long-term outlook for the crop-protection chemical industry, and we believe FMC is well-positioned to participate in industry growth trends with its leading product lineup.

Linde plc (Buy) - We believe the merger of Praxair and Linde created an industry leader in the attractive industrial gas market, which we like for its combination of growth and stability. We believe cost savings from the merger have created a more efficient company that will make it a formidable bidder for new projects with customers, ultimately driving market-share gains.

Nutrien (Buy) - Nutrien was formed by the 2018 merger of PotashCorp and Agrium. Nutrien's fertilizer production and retail businesses appear well-positioned to benefit from favorable long-term trends in agriculture, including a growing population of middle-income consumers with improving diets. We expect the company to continue to lower the production costs for fertilizers over the next few years, which bodes well for profitability.

BHP Group (Hold) - We anticipate slower growth out of China over the next few years, and a less resource-intensive type of growth. For BHP, China's slower growth likely means less demand for the commodities that it produces and slower future earnings growth. However, on valuation, we believe that the share price of BHP Group roughly reflects its future prospects.

Corteva (Buy) - Corteva is a leading provider of advanced technology seeds and crop-protection chemicals to the agriculture industry. We believe the company has a strong product lineup and an attractive balance across product categories, which should position the company well for capturing long-term demand for products that enhance the productivity of farmland.

Dow Inc. (Hold) - Dow is a leading independent producer of chemicals, plastics and packaging products serving a diverse array of end-markets spanning the global economy. We like the company's leading positions in its markets and its low-cost production capabilities, as well as the healthy dividend yield. However, we believe our modest long-term growth outlook is appropriately incorporated into the current share price.

DuPont (Hold) - We admire DuPont's diverse, innovative products serving a broad array of end-markets, including electronics, health care, housing and transportation. We expect DuPont's leadership to actively pursue divestitures and acquisitions to improve growth prospects and profitability. We believe the share price appropriately reflects our long-term growth outlook.

Ecolab (Buy) - is the world's largest provider of cleaning, sanitizing, disinfecting and pest-elimination solutions serving the restaurant, hotel and hospital markets. We recently upgraded Ecolab shares to a Buy rating from a Hold. Ecolab shares have underperformed the market and peers due to rising energy and raw material costs, which are weighing on profitability. We believe Ecolab will ultimately be able to offset rising costs through price increases and resume its long-term track record of producing solid earnings growth. Ecolab's core cleaning and sanitation business should see a solid rebound in demand as the economic reopening gains momentum and consumers resume travel and leisure activities. Long-term, we believe demand for Ecolab's products will benefit from the increased awareness of the importance of sanitation and the international-expansion opportunities.

Sherwin-Williams (Hold) - We believe Sherwin-Williams has an attractive business model, which is anchored on its more than 4,900 company-owned stores. We believe Sherwin-Williams remains well-positioned to benefit from solid paint demand supported by good remodel/repaint activity. However, at current levels, we believe the share price appropriately reflects these positives.

Environmental, Social, and Governance (ESG) Considerations

Chemical and commodity producers make up the majority of the materials sector. The key ESG issues associated with the sector primarily consist of carbon and water intensity, chemical safety and environmental litigation, and labor-safety track records. Environmental litigation can take many years to resolve, and can result in significant settlement and cleanup costs in severe cases. Chemical companies with significant exposure to plastic products tend to be scored lower by the ESG ratings agencies, unless they have robust plans and targets in place to improve recyclability or lower their use of power from carbon-based sources. Most of our materials companies do a good job of managing ESG-related risks.

Valuation

We approach valuation in many different ways in an effort to get a complete picture, as there is no perfect single approach to valuation. When valuing materials companies, we look at price-to-earnings ratios, enterprise value to EBITDA (earnings before interest, taxes, depreciation and amortization), discounted cash flow analysis, as well as net asset value and sum-of-the-parts calculations.

Risks

While we believe there are many attractive investment opportunities within the basic materials sector, there are several risks one should consider. The most notable risk for materials investors is a slowdown in global economic growth and the resulting downward pressure on key commodity prices. While materials companies are much larger and better diversified, at the end of the day they still sell a commodity at the market price. Should prices decline materially, it will likely manifest itself in lower profitability and earnings for the producers. The materials sector is very capital intensive and often requires a significant upfront investment to expand operations. The payback or return on investment is often uncertain and many years out. Furthermore, some producers may own and operate mines in politically unstable or unfriendly countries.

Sources:

[1] Agriculture Organization of the United Nations - "How to Feed the World 2050"
[2]United States Department of Agriculture - "2017 Census of Agriculture"

Please see the individual research reports for additional information, including disclosures, analyst certifications, valuation and risks specific to each company.

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