Edward Jones
MAKING SENSE OF INVESTING

The Less Basic, The Better

MATERIALS SECTOR REPORT

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ANALYST(S)

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Companies mentioned in this report:

Buy-rated Companies:
- **CCL Industries** (CCL.B.TO - C$50.87)
- **Corteva** (CTVA - $28.56)
- **FMC Corp** (FMC - $108.53)
- **Linde Plc** (LIN - $247.24)
- **Nutrien** (NTR - C$51.37)

Hold-rated Companies:
- **BHP Group** (BBL - $46.27)
- **Dow Inc.** (DOW - $44.64)
- **DuPont** (DD - $56.27)
- **Ecolab** (ECL - $194.06)
- **Sherwin-Williams** (SHW- $665.09)

Prices and opinion ratings are as of market close on 8/19/20 and subject to change. Source: Reuters.

Investment Overview

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 favourable 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.

Coronavirus Outbreak Creates Challenging Economic Environment

The materials sector is sensitive to commodity prices and general economic activity, both of which have been negatively impacted by the coronavirus outbreak. As a result, the sector has declined further than the broader S&P 500 year-to-date. We would expect the basic chemicals and metals producers to be most impacted, while the industrial gases and agriculture markets should be more resilient during the slowdown.

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.

We recommend 7% of your equity holdings consist of companies operating within the materials sector.

Please see important disclosures and analyst certification on pages 5 - 6 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 favourable 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.

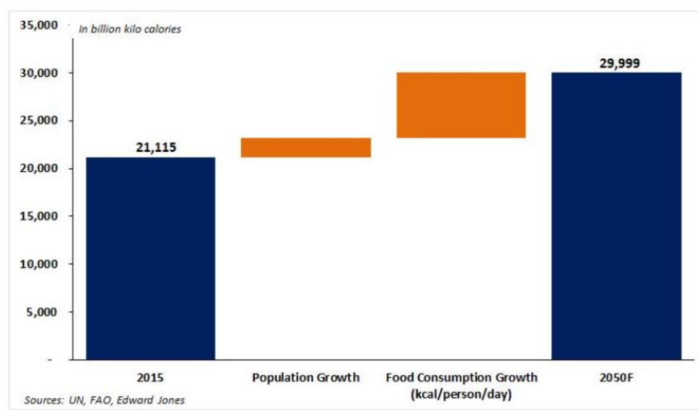
Coronavirus Outbreak Creates Challenging Economic Environment

The materials sector is sensitive to commodity prices and general economic activity, both of which have been negatively impacted by the coronavirus outbreak. As a result, the sector has declined further than the broader S&P 500 year-to-date. We would expect the basic chemicals and metals producers to be most impacted, while the industrial gases and agriculture markets should be more resilient during the slowdown. Industrial gas firms have long-term contracts that require minimum purchases, and agriculture activity should continue during the slowdown, as planting and harvest seasons are not typically affected by general economic 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 roughly 40% 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 40% increase in crop production will be required to feed the additional people. As seen in Figure 1 below, 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.

Figure 1: Projected Global Food Demand.



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. Farmers as a labour 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 and refined lithium products used in battery, health care, and industrial applications. We expect this unique combination of differentiated businesses should result in sustained above-average 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, which we believe to be the case for industrial gas provider Linde. We think the recently closed merger of Praxair and Linde can lead to further efficiency gains, which should drive higher profitability and opportunities to take market share.

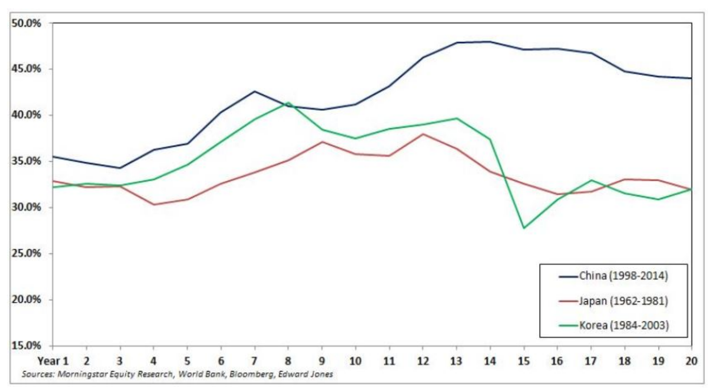
Cautious on iron ore, copper and steel-making-coal miners – On the negative side, we believe that the infrastructure build-out in China that characterized the last 20 years has probably peaked, meaning that we are likely past peak demand for many of the base metals. We are very cautious about the mining stocks that provide the basic materials used in China's construction market.

Infrastructure development in China has an outsized effect on metal prices – If China's property and infrastructure construction slows in the future, as we anticipate it will, the prices of basic materials used in China's construction market will likely fall, taking the stock prices of companies that mine those materials down with them. In many ways, China's economy is still a command economy, where the central government effectively determines the level of investment in property and infrastructure. Therefore, politics and the goals of the central government have a big effect on the level of investment.

In 2014 and 2015, reforms to China's economy caused prices for basic materials such as iron ore, copper and steel-making coal to fall dramatically. The reforms were intended to diversify China's economy away from investment in property and infrastructure. China has built out its stock of infrastructure and property over the last 20 years to the point where some people, including some officials in China's central government, consider the build-out to be a bubble.

As you can see in Figure 2, China has allocated a much greater portion of its resources to investment in property and infrastructure than did other countries during similar periods of rapid development. The higher level of investment probably is due to greater central management of the economy, leading to overinvestment by local officials. The high level of investment in China is even more striking when you think about the total destruction of Japan after World War II as a starting point for its development.

Figure 2: Investment as a Share of GDP During Periods of Rapid Development.



Global economic growth has been solid, and we expect growth to continue in both the U.S. and Europe. However, China is such a large consumer of raw materials that changes in its construction markets should swamp the effects of higher growth in the U.S. and Europe. As an indication of how big a consumer China currently is in the basic-material world, in 2019, the World Steel Association estimates that China produced 53% of all global steel. China also consumes around half of the global production of several base metals. Statista estimates that China's consumption was around 51% of all the refined copper produced globally in 2019. Given these numbers, it is easy to see why changes to China's growth have such a big effect on global demand for basic materials.

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 30% of electricity production in the U.S. and 69% in China. 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) - We have favourable outlooks for the two businesses that remain following FMC's recently closed asset swap with DuPont: crop-protection chemicals and lithium. We believe this deal improves FMC's position in agriculture and provides the company a strong earnings outlook over the next few years that is not yet fully reflected in the stock price.

Linde plc (Buy) - We believe the merger of Praxair and Linde forms an industry leader in the attractive industrial gas industry, which we like for its combination of growth and stability. Linde is targeting $1 billion in cost savings over the next three years, which we believe will lead to solid earnings growth that can average 13% over the next few years. Our forecast is further supported by the company's exposure to positive trends such as growing demand for low-cost natural gas, clean energy, emerging-markets growth, and manufacturing efficiency.

Nutrien (Buy) - Effective January 1, 2018, PotashCorp and Agrium merged into a new company called Nutrien. We believe that Nutrien will be able to cut overlapping costs within its new structure, creating faster medium-term earnings growth. Nutrien's business appears well positioned to benefit from a long-term move toward higher-yielding, customized farming techniques on North American farms, and from increasing global food demand.

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) - After being spun off from DowDuPont, Corteva is a leading independent 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. At current levels, the share price does not adequately reflect our positive outlook, in our view.

CCL Industries (Buy) - CCL is a global leader in the production of labels, and it is growing its business through acquisitions. CCL has proven itself to be skilled at buying good businesses and improving their operations and profitability. We expect that core business growth, complemented by acquisitions, should produce attractive earnings growth over time. We think shares are currently attractively priced for long-term investors.

Dow Inc. (Hold) - After being spun off from DowDuPont, 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 6.5% dividend yield. However, we believe our modest long-term growth outlook is appropriately incorporated into the current share price. At current levels, Dow trades at a modest valuation premium to its most comparable peers, which we feel is warranted by its attractive return of cash to shareholders.

DuPont (Hold) - We admire DuPont's diverse portfolio of innovative products serving a broad array of end-markets including electronics, food & beverage, health care, housing, and transportation. With the breakup of DowDuPont now complete, we expect DuPont's leadership to actively manage the portfolio via divestitures and acquisitions to drive higher growth and profitability over time. At current levels, we believe the share price appropriately reflects our long-term growth outlook.

Ecolab (Hold) - is the world's largest provider of cleaning, sanitizing, disinfecting and pest-elimination solutions serving the restaurant, hotel and hospital markets. Following recent share-price appreciation, we believe our positive long-term growth outlook is adequately reflected in the stock. We continue to like the stable growth profile of Ecolab's core cleaning and sanitation business. Also, we expect earnings from the company's energy business to continue their gradual recovery. We also think management's decision to separate the energy business via a spinoff is a positive for shareholders, as we would expect a more stable earnings-growth profile from Ecolab following the completion of the separation.

Sherwin-Williams (Hold) - We believe Sherwin-Williams has an attractive business model, which is anchored on its more than 4,200 company-owned stores. We believe Sherwin-Williams remains well-positioned to benefit from solid paint demand supported by good remodel/repaint activity. Additionally, we believe the acquisition of Valspar provides opportunities to improve profitability. However, at current levels, we believe the share price appropriately reflects these positives.

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.

Please see our opinion on each of the companies mentioned in this report for more information on the benefits, valuation, and risks of investing in these stocks.

Required Research Disclosures

Analyst Certification

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