

Fletcher Building

UNDERPERFORM

FY19 Preview — Competitive, cost and macro pressures

Fletcher Building (FBU) reports its FY19 result on 21 August — whilst much was preannounced at June's investor day we expect the result will reaffirm a business facing macro (in Australia), competitive and cost pressures. Although FBU does not typically provide guidance at its full year result, we suspect any outlook commentary would dampen FY20 expectations — our FY20E EBIT/NPAT is -8%/-14% below consensus.

Key issues to watch for:

- **Underlying earnings decline:** FBU has guided to FY19 EBIT down -8–13% (ex. prior year construction losses). Our FY19E EBIT comprises NZ products/distribution down -12% (despite growth in construction activity), NZ homebuilding -3% or -15% excl. prior year provisions, and AU -55%.
- **Weak cash flow:** We anticipate negative NZ\$(256)m free cash flow, before asset sales, impacted by crystallisation of construction losses and capex materially > depreciation.
- **Margin pressure on Fletcher Living:** We expect FBU's homebuilding margins to have been impacted by softening Auckland house prices and demand, a headwind which is likely to exacerbate into FY20.
- **Construction challenges:** Our base case view remains that FBU has "kitchen sinked" its Building and Interiors (B&I) provisions, and additional losses are unlikely despite further project delays. Industry anecdotes and FBU's lack of profit recognition to date suggest its Infrastructure division is also grappling with project delays and cost overruns.
- **Tough Australian backdrop:** It feels too early for FBU to revise its guidance of improved AU earnings in FY20; however, conviction in self-help initiatives will need to be reaffirmed to provide confidence that its AU businesses can withstand sharply declining demand.
- **Dividend:** FBU has previously guided to its reinstated dividend being 2H weighted. We expect it will not be imputed/franked for NZ/AU tax purposes.

Investor briefing

Conference call: 11.00am (NZ time), NZ 0800 667 018, AU 1 800 148 258, US 186 6586 2813, Hong Kong 800 965 808. Passcode: **1056759**. Webcast: <https://edge.media-server.com/mmc/p/f9bc0hz6>

Figure 1. FBU FY19E forecasts

NZ\$m	FY18	FY19E	% chg
Revenue	9,471	9,508	0.4%
EBIT	50	627	na
EBIT (excluding construction losses)	710	627	-11.7%
Underlying profit	(60)	357	na
Underlying EPS (cps)	(8.3)	42.0	na
Dividend (cps)	0.0	23.0	na

Source: Company reports, Forsyth Barr analysis

Investment View

We believe FBU will likely disappoint market earnings expectations again in FY20/21. The stock's valuation "discount" vs. sector peers and the broader market masks weak medium-term free cash flow and peak cycle demand. UNDERPERFORM.

NZX Code	FBU
Share price	NZ\$4.52
Target price	NZ\$4.65
Risk rating	Medium
Issued shares	850.5m
Market cap	NZ\$3,844m
Average daily turnover	1,299k (NZ\$6,804k)

Share Price Performance



Financials: June	18A	19E	20E	21E
NPAT* (NZ\$m)	-60.0	357.2	285.1	282.4
EPS* (NZc)	-8.3	42.0	33.5	33.2
EPS growth* (%)	n/a	n/a	-20.2	-0.9
DPS (NZc)	0.0	23.0	23.0	23.0
Imputation (%)	100	0	100	100

Valuation (x)	18A	19E	20E	21E
EV/EBITDA	19.9	5.4	5.7	5.6
EV/EBIT	n/a	7.1	8.0	8.0
PE	n/a	10.8	13.5	13.6
Price / NTA	1.6	1.3	1.3	1.2
Cash dividend yield (%)	0.0	5.1	5.1	5.1
Gross dividend yield (%)	0.0	5.1	7.1	7.1

*Historic and forecast numbers based on underlying profits

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Fletcher Building (FBU)		Priced as at 16 Aug 2019: NZ\$4.52					June year end					
Forsyth Barr valuation						Valuation Ratios						
Valuation methodology		DCF, sector peer relative, mid-cycle				EV/EBITDA (x)	2017A	2018A	2019E	2020E	2021E	
12-month target price (NZ\$)*		4.65		Spot valuations (NZ\$)		EV/EBIT (x)	10.2	>100x	7.1	8.0	8.0	
Expected share price return		2.9%		1. DCF		4.64	PE (x)	9.7	n/a	10.8	13.5	13.6
Net dividend yield		5.1%		2. Sector peer relative		5.59	Price/NTA (x)	1.7	1.6	1.3	1.3	1.2
Estimated 12-month return		8.0%		3. Mid-cycle		4.42	Free cash flow yield (%)	-2.0	2.4	-6.4	-0.1	5.3
Key WACC assumptions		DCF valuation summary (NZ\$m)				Net dividend yield (%)	8.6	0.0	5.1	5.1	5.1	
Risk free rate		2.75%		Total firm value		3,772	Gross dividend yield (%)	12.0	0.0	5.1	7.1	7.1
Equity beta		1.31		(Net debt)/cash		(1,273)	Imputation (%)	100	100	0	100	100
WACC		9.3%		Value of equity		2,499	Pay-out ratio (%)	84	0	55	69	69
Terminal growth		2.0%		Shares (m)		851	Capital Structure					
Profit and Loss Account (NZ\$m)		2017A		2018A		2019E		2020E		2021E		
Sales revenue		9,399		9,471		9,508		8,063		8,239		
Normalised EBITDA		728		264		828		693		713		
Depreciation and amortisation		(203)		(214)		(201)		(195)		(217)		
Normalised EBIT		525		50		627		498		496		
Net interest		(111)		(157)		(130)		(86)		(87)		
Associate income		-		-		-		-		-		
Tax		(82)		58		(129)		(116)		(114)		
Minority interests		11		11		11		11		12		
Normalised NPAT		321		(60)		357		285		282		
Abnormals/other		227		130		216		26		-		
Reported NPAT		94		(190)		142		260		282		
Normalised EPS (cps)		46.5		(8.3)		42.0		33.5		33.2		
DPS (cps)		39.0		-		23.0		23.0		23.0		
Growth Rates		2017A		2018A		2019E		2020E		2021E		
Revenue (%)		4.4		0.8		0.4		-15.2		2.2		
EBITDA (%)		-16.9		-63.7		>100		-16.3		2.8		
EBIT (%)		-23.0		-90.5		>100		-20.6		-0.5		
Normalised NPAT (%)		-23.2		n/a		n/a		-20.2		-0.9		
Normalised EPS (%)		-23.5		n/a		n/a		-20.2		-0.9		
DPS (%)		0.0		-100.0		n/a		0.0		0.0		
Cash Flow (NZ\$m)		2017A		2018A		2019E		2020E		2021E		
EBITDA		728		264		828		693		713		
Working capital change		(176)		430		(498)		(167)		99		
Interest & tax paid		(224)		(243)		(160)		(129)		(202)		
Other		(85)		(55)		(50)		(15)		-		
Operating cash flow		243		396		121		382		610		
Capital expenditure		(319)		(304)		(365)		(387)		(405)		
(Acquisitions)/divestments		(292)		76		1,234		-		-		
Other		-		-		-		-		-		
Funding available/(required)		(368)		168		990		(5)		205		
Dividends paid		(246)		(123)		(68)		(221)		(196)		
Equity raised/(returned)		32		893		-		-		-		
Increase/(decrease) in net debt		582		(938)		(922)		226		(9)		
Balance Sheet (NZ\$m)		2017A		2018A		2019E		2020E		2021E		
Working capital		1,771		1,830		1,865		1,775		1,701		
Fixed assets		2,214		2,241		1,684		1,861		2,049		
Intangibles		1,678		1,686		1,181		1,181		1,181		
Other assets		385		563		493		424		424		
Total funds employed		6,048		6,320		5,223		5,241		5,355		
Net debt/(cash)		1,953		1,273		354		602		605		
Other non current liabilities		515		905		645		387		412		
Shareholder's funds		3,556		4,118		4,200		4,228		4,314		
Minority interests		24		24		24		24		24		
Total funding sources		6,048		6,320		5,223		5,241		5,355		
Key Ratios		2017A		2018A		2019E		2020E		2021E		
Return on assets (%)		6.8		0.6		8.0		6.5		6.4		
Return on equity (%)		9.0		-1.5		8.5		6.7		6.5		
Return on funds employed (%)		7.5		-1.1		8.6		7.1		6.8		
EBITDA margin (%)		7.7		2.8		8.7		8.6		8.7		
EBIT margin (%)		5.6		0.5		6.6		6.2		6.0		
Capex to sales (%)		3.4		3.2		3.8		4.8		4.9		
Capex to depreciation (%)		157		142		182		198		187		
Operating Performance		2017A		2018A		2019E		2020E		2021E		
External revenue (NZ\$m)		2017A		2018A		2019E		2020E		2021E		
Concrete		507		545		551		583		598		
Building Products		589		613		612		617		634		
Distribution		1,470		1,490		1,559		1,621		1,673		
Steel		378		411		432		458		469		
Construction		2,085		1,605		1,619		1,322		1,354		
Residential and Land Development		420		575		631		582		598		
Australia		2,771		2,973		2,971		2,879		2,912		
International		1,101		1,151		1,134		-		-		
Divested		78		108		-		-		-		
Total external revenue		9,399		9,471		9,508		8,063		8,239		
New Zealand		5,381		5,220		5,290		5,050		5,191		
Australia		2,766		3,018		2,979		2,887		2,920		
Rest of World		1,252		1,233		1,239		125		128		
Total external revenue		9,399		9,471		9,508		8,063		8,239		
EBIT (NZ\$m)		2017A		2018A		2019E		2020E		2021E		
Concrete		113		90		83		94		92		
Building Products		152		132		125		112		109		
Distribution		104		104		105		108		111		
Steel		54		49		39		40		41		
Construction		(204)		(608)		43		42		43		
Residential and Land Development		130		136		137		99		101		
Australia		119		114		56		58		55		
International		79		65		80		-		-		
Divested		7		13		-		-		-		
Other		(30)		(45)		(40)		(55)		(56)		
Total EBIT		524		50		627		498		496		
New Zealand		282		(172)		453		410		410		
Australia		120		123		57		58		55		
Rest of World		122		99		118		30		30		
Total EBIT		524		50		627		498		496		

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

Figure 2. FY19E earnings forecasts

NZ\$m	FY18	FY19E	% chg	Forbar	% diff
Revenue	9,471	9,508	0.4%	9,881	-3.8%
EBIT (by division)					
Concrete	90	83	-8.0%	90	-7.5%
Building Products	132	125	-5.6%	133	-6.7%
Distribution	104	105	0.8%	106	-1.5%
Steel	49	39	-20.9%	51	-23.4%
Construction	(608)	43	-107.1%	(605)	-107.1%
Residential and Land Development	136	137	1.0%	133	3.1%
Australia	114	56	-51.1%	114	-51.1%
International	65	80	23.1%	66	21.3%
Divested	13	0	-100.0%	13	-100.0%
Other	(45)	(40)	-11.1%	(50)	-20.0%
Total EBIT	50	627	1154.2%	52	1111.3%
EBIT (by geography)					
New Zealand	(172)	453	-363.2%	(181)	-349.9%
Australia	123	57	-53.9%	128	-55.8%
Rest of world	75	114	52.5%	101	13.2%
Reported profit	(190)	142	-174.5%	(119)	-219.0%
Underlying profit	(60)	357	-695.3%	(66)	-640.1%
Underlying EPS (cps)	(8.3)	42.0	-604.8%	(9.2)	-557.6%
Dividend (cps)	0.0	23.0	nm	0.0	nm

Source: Company reports, Forsyth Barr analysis

Investment summary

Over the past decade FBU has been a perennial disappointment vs. market expectations; unfortunately, we see a high risk of it doing so again over FY20/21 given the plethora of competitive, macro, and operational challenges it faces. Whilst FBU's valuation multiples appear *prima facie* unchallenging relative to an elevated market, they must be put in context of (1) key cyclical exposures being at near record levels, and (2) weak medium-term cash flow impacted by extended elevated capex and crystallisation of construction losses. **UNDERPERFORM.**

Business quality

- **Competition pressuring NZ franchises:** Whilst FBU's NZ businesses typically maintain leading market positions, over the past decade the strength of these positions has generally deteriorated with increased domestic and import competition pressuring margins and market share (a trend we expect will continue).
- **Low quality Australian portfolio:** FBU's poor performing Australian businesses currently earn a c.2% EBIT return on the c.NZ\$3b acquisition cost. FBU is aiming to 4x its Australian EBIT over the next five years through improved margins and new investment. We are sceptical given competitive constraints and high operating leverage to slowing demand.

Earnings and cash flow outlook

- **Consensus expectations too high:** Our FY19/20/21E EBIT is -2%/-8%/-10% below analyst consensus forecasts, translating through to NPAT -2%/-15%/-15% under.
- **Limited medium-term free cash flow:** Forecast medium-term FCF yield: FY20/21/22E -1%/4%/3% reflecting crystallisation of construction losses and capex materially > depreciation.
- **Strong balance sheet and capital management:** Proceeds from the sale of Formica will lower FBU's net debt to c.0.5x, significantly below its 1.5–2.5x EBITDA target. FBU intends to return "up to NZ\$300m" through an on-market buyback commencing post its FY19 result.

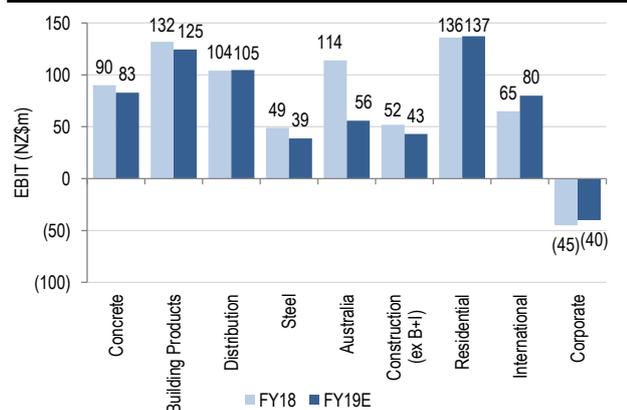
Risks factors

- **Construction cycles in NZ and Australia:** FBU is levered to cyclical construction activity in NZ and AU, weighted to residential in both markets.
- **Competitive pressures:** Competition and cost inflation could materially influence FBU's market share and margins.
- **Construction losses:** Consensus view is that company has likely "kitchen sinked" its loss provisions, but the risk will not be extinguished until the projects are complete. Anecdotes of staff losses and project issues persist.

Company description

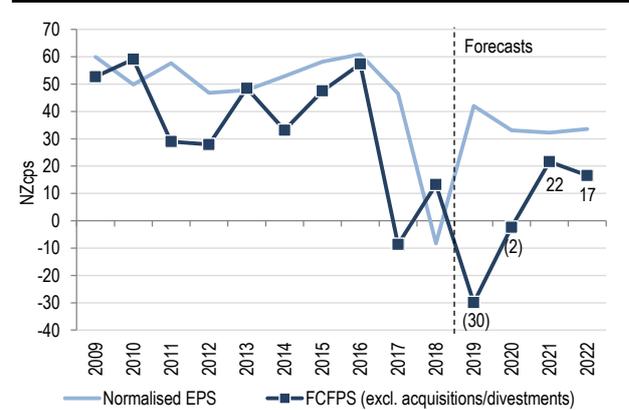
FBU is NZ's largest building materials and construction company. Operations include: (1) the manufacturing of a broad range of light and heavy building materials including cement, aggregates, concrete products, plasterboard, insulation and plastic pipes in NZ and Australia, (2) two global businesses manufacturing laminates and panels and roof tiles, (3) building distribution businesses including Placemakers (NZ), Mico (NZ) and Tradelink (Australia), (4) Fletcher Construction, NZ's largest construction company, and (5) Fletcher Living, a NZ homebuilder.

Figure 3. Divisional EBIT



Source: Company reports, Forsyth Barr analysis

Figure 4. EPS and FCFPS



Source: Company reports, Forsyth Barr analysis

Figure 5. Substantial Shareholders

Shareholder	Latest Holding
Perpetual	11.2%
Schroder Investment Management Group	7.4%
Commonwealth Bank of Australia	6.0%
The Vanguard Group	5.6%

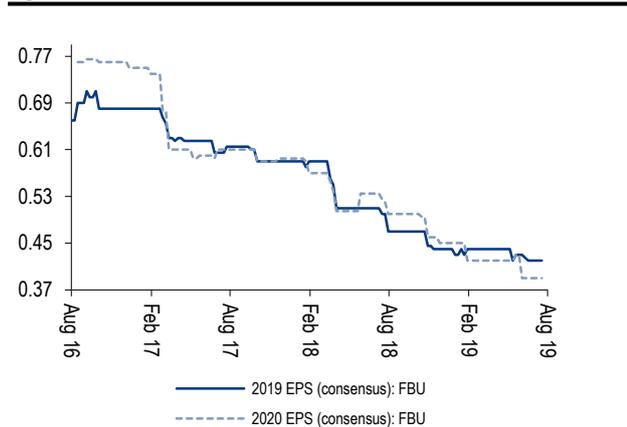
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 6. International Compco's

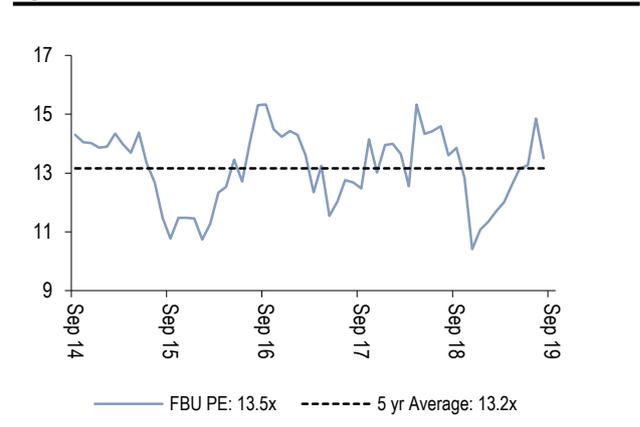
Company <i>(metrics re-weighted to reflect FBU's balance date - June)</i>	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash D/Yld 2020E
				2019E	2020E	2019E	2020E	2019E	2020E	
Fletcher Building	FBU NZ	NZ\$4.52	NZ\$3,844	10.8x	13.5x	6.2x	7.4x	8.2x	10.3x	5.1%
Metro Performance Glass *	MPG NZ	NZ\$0.35	NZ\$65	4.5x	4.3x	3.7x	3.8x	5.8x	5.8x	3.1%
Steel & Tube Holdings *	STU NZ	NZ\$0.93	NZ\$154	14.6x	13.0x	10.6x	10.3x	15.2x	14.3x	6.5%
Adelaide Brighton	ABC AT	A\$3.21	A\$2,092	13.8x	16.1x	8.7x	9.2x	12.3x	13.3x	3.4%
Boral	BLD AT	A\$5.01	A\$5,873	12.7x	12.2x	7.8x	7.6x	12.7x	12.3x	5.3%
CSR	CSR AT	A\$3.88	A\$1,932	22.1x	13.6x	6.8x	7.1x	9.3x	9.6x	5.8%
DuluxGroup	DLX AT	A\$9.35	A\$3,639	24.5x	24.6x	15.8x	15.6x	18.0x	17.7x	3.6%
GWA Group	GWA AT	A\$3.39	A\$895	16.9x	15.3x	10.7x	9.2x	11.3x	10.0x	5.5%
James Hardie Industries PLC	JHX AT	US\$15.26	US\$6,749	26.8x	18.7x	16.1x	12.7x	21.3x	16.2x	3.0%
Reece	REH AT	A\$10.09	A\$5,659	21.1x	20.4x	10.3x	10.0x	12.3x	12.0x	2.2%
CRH PLC	CRH ID	€28.41	€22,643	11.4x	12.8x	8.2x	7.2x	12.5x	11.0x	2.7%
LafargeHolcim	LHN SW	CHF45.59	CHF28,080	15.5x	12.3x	7.3x	6.1x	12.4x	9.9x	4.4%
Compco Average:				16.7x	14.9x	9.6x	9.0x	13.0x	12.0x	4.1%
FBU Relative:				-36%	-9%	-36%	-18%	-37%	-14%	+23%

EV = Current Market Cap + Actual Net Debt

Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (FBU) companies fiscal year end

Figure 7. Consensus EPS Momentum


Source: Forsyth Barr analysis, Bloomberg

Figure 8. 12 Month Forward PE


Source: Forsyth Barr analysis

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