FORSYTH BARR

Fletcher Building

UNDERPERFORM

FY19 Result — No News is Good News

Fletcher Building's (FBU) stock price bounced on the back of a result that, in our view, provided no new information. Recent weakness suggested some feared bad news, possibly from declining demand in Australia or ongoing construction project delays. There is no change to our investment view — we see a raft of challenges that could cause FBU to disappoint vs. market expectations over FY20, with value insufficient to compensate. Maintain UNDERPERFORM.

What's changed?

- **Earnings:** Minor operating changes, and we factor in the NZ$300m share buyback. Our forecasts do not yet incorporate IFRS16 impacts.

Result effectively preannounced; margin pressure a consistent theme

Not surprisingly, FBU's FY19 result was in line with the headline guidance and detail provided at June's investor day, and minimal new information was provided. The result did serve to reemphasise a few of our concerns:

- NZ EBIT (ex. Construction/Housing) was down -6% on revenue +2% and vs. c.+3% growth in construction activity, with margins pressured by cost and competition. All NZ divisions (Building Products, Steel, Concrete, Distribution) saw EBIT margins fall. We expect these pressures will continue and may be exacerbated by easing demand.
- Homebuilding margins fell to NZ$111k per house/section, from NZ$136k, despite 97% of sales being houses (not section only) vs. 86% in the pcp. FBU attributed the lower margins to geographical mix. We suspect FBU will struggle to sustain margins given softening Auckland prices and demand.
- The Building & Interiors (B&I) Construction loss provision is unchanged, but profit contribution to Construction outside Higgins and South Pacific remain minimal. Industry anecdotes and FBU's lack of profit recognition to date suggest its Infrastructure division is also grappling with project challenges.
- The halving of AU EBIT despite flat revenue also emphasised that competition and cost pressures have been principal impacts. FBU's ambition to deliver meaningful earnings improvement, with demand now going backward, feels ambitious.

Downside risk to expectations

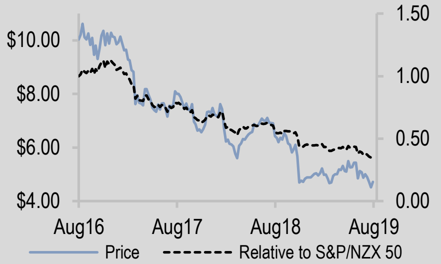
On a run-rate basis FY19 equates to EBIT of c.NZ$512m excluding divestments, excess land sales gains, and other one-off impacts. Looking to FY20 FBU has painted a picture of a broadly stable underlying NZ business, with cost savings and efficiency investments delivering growth in AU. The analyst consensus appears to have taken this at face value: FY20E NZ$539m, range NZ$470–670m (pre result). This would require a positive swing in momentum at a time when the environment is only getting more challenging. History firmly suggests investors should take a cautious view when evaluating FBU's outlook. We view the risk to our and market expectations as negative.

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$4.72
Target price	NZ$4.65
Risk rating	Medium
Issued shares	850.8m
Market cap	NZ$4,016m
Average daily turnover	1,316k (NZ$6,868k)

Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ$m)	367.0	290.6	291.5	305.4
EPS* (NZc)	43.1	35.4	36.9	38.7
EPS growth* (%)	n/a	-17.9	4.2	4.8
DPS (NZc)	23.0	23.0	24.0	25.0
Imputation (%)	0	65	67	64

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	5.7	6.4	6.6	6.2
EV/EBIT	7.4	8.9	9.5	9.2
PE	10.9	13.3	12.8	12.2
Price / NTA	1.3	1.3	1.3	n/a
Cash dividend yield (%)	4.9	4.9	5.1	5.3
Gross dividend yield (%)	4.9	6.1	6.4	6.6

*Historic and forecast numbers based on underlying profits

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Fletcher Building (FBU) Priced as at 21 Aug 2019: NZ$4.72 June year end

Forsyth Barr valuation			
Valuation methodology		DCF, sector peer relative, mid-cycle	
12-month target price (NZ$)*	**4.65**	**Spot valuations (NZ$)**	
Expected share price return	-1.5%	1. DCF	4.41
Net dividend yield	4.9%	2. Sector peer relative	5.35
Estimated 12-month return	3.4%	3. Mid-cycle	4.42
Key WACC assumptions		**DCF valuation summary (NZ$m)**	
Risk free rate	2.00%	Total firm value	3,873
Equity beta	1.31	(Net debt)/cash	(325)
WACC	8.9%	Value of equity	3,548
Terminal growth	1.5%	Shares (m)	851

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	9,471	9,307	8,091	8,194	8,324
Normalised EBITDA	**264**	**830**	**704**	**724**	**765**
Depreciation and amortisation	(214)	(199)	(199)	(222)	(251)
Normalised EBIT	**50**	**631**	**505**	**502**	**514**
Net interest	(157)	(118)	(82)	(78)	(72)
Associate income	-	-	-	-	-
Tax	58	(133)	(119)	(119)	(124)
Minority interests	11	13	13	14	13
Normalised NPAT	**(60)**	**367**	**291**	**291**	**305**
Abnormals/other	130	203	26	-	-
Reported NPAT	**(190)**	**164**	**265**	**291**	**305**
Normalised EPS (cps)	(8.3)	43.1	35.4	36.9	38.7
DPS (cps)	-	23.0	23.0	24.0	25.0

Growth Rates	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue (%)	0.8	-1.7	-13.1	1.3	1.6
EBITDA (%)	-63.7	>100	-15.2	2.8	5.7
EBIT (%)	-90.5	>100	-20.0	-0.6	2.5
Normalised NPAT (%)	n/a	n/a	-20.8	0.3	4.8
Normalised EPS (%)	n/a	n/a	-17.9	4.2	4.8
DPS (%)	-100.0	n/a	0.0	4.3	4.2

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**264**	**830**	**704**	**724**	**765**
Working capital change	430	(404)	(194)	(10)	(2)
Interest & tax paid	(243)	(156)	(124)	(196)	(196)
Other	(55)	(117)	(15)	-	-
Operating cash flow	**396**	**153**	**370**	**518**	**568**
Capital expenditure	(304)	(348)	(387)	(405)	(390)
(Acquisitions)/divestments	76	1,262	-	-	-
Other	-	-	-	-	-
Funding available/(required)	**168**	**1,067**	**(17)**	**113**	**178**
Dividends paid	(123)	(68)	(193)	(182)	(197)
Equity raised/(returned)	893	(81)	(300)	-	-
Increase/(decrease) in net debt	**(938)**	**(918)**	**510**	**69**	**20**

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	1,641	1,384	1,321	1,274	1,279
Fixed assets	2,231	1,754	1,927	2,110	2,249
Intangibles	1,696	1,129	1,129	1,129	1,129
Other assets	765	817	745	745	745
Total funds employed	**6,333**	**5,084**	**5,123**	**5,258**	**5,403**
Net debt/(cash)	1,273	325	862	938	972
Other non current liabilities	918	586	329	271	275
Shareholder's funds	4,118	4,141	3,899	4,016	4,124
Minority interests	24	32	32	32	32
Total funding sources	**6,333**	**5,084**	**5,123**	**5,258**	**5,403**

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	20.7	5.7	6.4	6.6	6.2
EV/EBIT (x)	>100x	7.4	8.9	9.5	9.2
PE (x)	n/a	10.9	13.3	12.8	12.2
Price/NTA (x)	1.7	1.3	1.3	1.3	1.2
Free cash flow yield (%)	2.3	-4.9	-0.4	2.8	4.4
Net dividend yield (%)	0.0	4.9	4.9	5.1	5.3
Gross dividend yield (%)	0.0	4.9	6.1	6.4	6.6
Imputation (%)	100	0	65	67	64
Pay-out ratio (%)	0	53	65	65	65

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	0.3	5.3	6.2	6.5	7.2
Interest cover EBITDA (x)	1.7	7.0	8.6	9.3	10.7
Net debt/ND+E (%)	23.6	7.3	18.1	18.9	19.1
Net debt/EBITDA (x)	4.8	0.4	1.2	1.3	1.3

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	0.6	8.2	7.0	6.9	6.9
Return on equity (%)	-1.5	8.9	7.5	7.3	7.4
Return on funds employed (%)	-1.1	8.8	7.3	6.9	6.9
EBITDA margin (%)	2.8	8.9	8.7	8.8	9.2
EBIT margin (%)	0.5	6.8	6.2	6.1	6.2
Capex to sales (%)	3.2	3.7	4.8	4.9	4.7
Capex to depreciation (%)	142	175	195	182	156

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
External revenue (NZ$m)					
Concrete	545	549	583	598	608
Building Products	613	587	604	620	627
Distribution	1,490	1,552	1,659	1,712	1,725
Steel	411	426	452	463	470
Construction	1,605	1,622	1,335	1,368	1,401
Residential and Land Developmen	575	639	592	607	635
Australia	2,972	2,933	2,867	2,826	2,858
International	-	-	-	-	-
Divested	1,260	999	-	-	-
Total external revenue	**9,471**	**9,307**	**8,091**	**8,194**	**8,324**
New Zealand	5,063	5,220	5,080	5,221	5,316
Australia	3,018	2,944	2,857	2,817	2,849
Rest of World	1,390	1,143	154	157	160
Total external revenue	**9,471**	**9,307**	**8,091**	**8,194**	**8,324**
EBIT (NZ$m)					
Concrete	90	84	95	93	92
Building Products	132	127	114	111	106
Distribution	104	104	107	110	107
Steel	49	33	37	38	41
Construction	(608)	47	47	48	57
Residential and Land Developmen	136	137	101	103	107
Australia	114	57	59	55	62
International	-	-	-	-	-
Divested	78	82	-	-	-
Other	(45)	(40)	(55)	(56)	(57)
Total EBIT	**50**	**631**	**505**	**502**	**514**
New Zealand	(180)	467	432	432	438
Australia	123	54	52	48	55
Rest of World	107	110	21	21	22
Total EBIT	**50**	**631**	**505**	**502**	**514**

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

Result analysis

Figure 1. FY19 result analysis

NZ$m	FY18	FY19	% chg	Forbar	% diff	
Revenue						
Concrete	545	549	0.7%	551	-0.4%	Cement volumes -2%, aggregates +8%, RMC flat.
Building Products	613	587	-4.2%	612	-4.0%	Plasterboard +7%, and insulation +5%, offset by declines in plastic and concrete pipes.
Distribution	1,490	1,552	4.2%	1,559	-0.5%	PlaceMakers +4%, Mico +4%, led by a buoyant Auckland market, and improved Waikato-BoP in 2H.
Steel	411	426	3.6%	432	-1.3%	Volumes: Easysteel +3%, PCC +7%, Reinforcing -3%.
Construction	1,605	1,622	1.1%	1,619	0.2%	Growth from infrastructure/civil offset by reduced B+I revenue.
Residential and Land Development	575	639	11.1%	631	1.3%	Residential revenue +13%. Total units sold +6% to 755.
Australia	2,972	2,933	-1.3%	2,971	-1.3%	Laminex -6% and Steel -3%, driven by AU residential downturn and increased competition. Distribution flat.
Divested	1,260	999	nm	1,134	-11.9%	Formica divested 3 June 2019.
Total revenue	**9,471**	**9,307**	**-1.7%**	**9,508**	**-2.1%**	
EBIT						
Concrete	90	84	-6.7%	83	1.4%	Up +2% excl. NZ$(7)m impact of cement mill outage.
Building Products	132	127	-3.8%	125	2.0%	Plasterboard and insulation growth offset by input cost increases and a decline in plastic and concrete pipes.
Distribution	104	104	0.0%	105	-0.8%	Margins pressured by labour costs, competition, and digital investment (Snappy).
Steel	49	33	-32.7%	39	-14.9%	Step increase in competitive pressures, with Steel & Tube looking to take market share.
Construction	(608)	47	na	43	9.2%	Minimal contribution outside of Higgins and South Pacific. B&I loss in the pcp.
Residential and Land Development	136	137	0.7%	137	-0.2%	Residential -13%, attributed to higher portion of sales in lower margin Christchurch. Land development +NZ$5m.
Australia	114	57	-50.0%	56	2.2%	Impacted by competition and input cost inflation. Building products -47%, Distribution -38%, Steel -56%.
Divested	78	82	na	80	2.5%	
Other	(45)	(40)	-11.1%	(40)	0.0%	
EBIT (before significant items)	**50**	**631**	**nm**	**627**	**0.6%**	
EBIT (excl. Construction losses + divestments)	**632**	**549**	**-13.1%**	**547**	**0.3%**	
Significant items	(168)	(234)	39.3%	(245)	-4.5%	RTG loss on sale NZ$(18)m, Formica loss on sales NZ$(122)m, and restructuring costs NZ$(94)m.
EBIT	**(118)**	**397**	**na**	**382**	**3.9%**	
Interest	(157)	(118)	-24.8%	(130)	-8.9%	Lower debt. Additional interest charges from covenant breach ceased 3Q19.
Net profit before tax	**(275)**	**279**	**na**	**253**	**10.5%**	
Tax	96	(102)	-206.3%	(100)	2.1%	
Net profit after tax	**(179)**	**177**	**na**	**153**	**15.9%**	
Minorities	(11)	(13)	18.2%	(11)	17.3%	
Reported profit	**(190)**	**164**	**na**	**142**	**15.8%**	
Underlying profit	**(60)**	**367**	**na**	**357**	**2.7%**	
Underlying EPS (cps)	(8.3)	43.1	nm	42.0	2.7%	
Dividend (cps)	0.0	23.0	nm	23.0	0.0%	Final div 15cps. No imputation/franking credits attached.

Source: Company reports, Forsyth Barr analysis

Earnings revisions

Minor operating changes, and we factor in the NZ$300m share buyback.

Our forecasts do not yet incorporate IFRS16 impacts.

Figure 2. Earnings revisions

	FY20E			FY21E			FY22E
NZ$m	**Old**	**New**	**% chg**	**Old**	**New**	**% chg**	**New**
Revenue	8,063	8,092	0.4%	8,239	8,195	-0.5%	8,363
EBITDA	693	704	1.6%	713	724	1.6%	762
EBIT	498	505	1.4%	496	502	1.2%	516
Underlying NPAT	285	290	1.8%	282	290	2.7%	300
Underlying EPS (cps)	33.5	35.4	5.6%	33.2	36.8	10.7%	35.2
Dividend (cps)	23.0	23.0	0.0%	23.0	24.0	4.3%	25.0

Source: Forsyth Barr analysis

Investment summary

Over the past decade FBU has been a perennial disappointer 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 FY20/21E EBIT is -7%/-7% below (pre result) analyst consensus forecasts, translating through to EPS -11%/-12% under.
- **Limited medium-term free cash flow:** Forecast medium-term FCF yield: FY20/21/22E -1%/3%/4% 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.

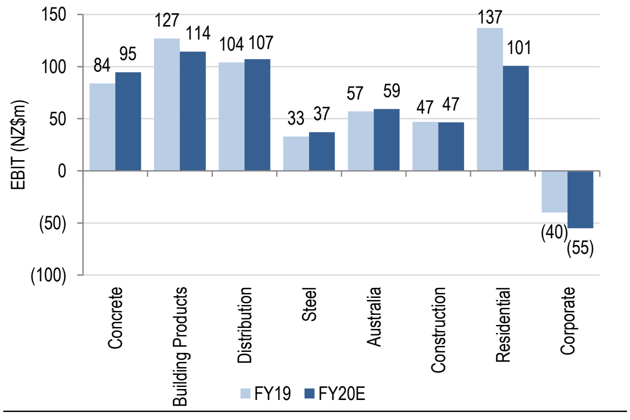
Risks factors

- **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

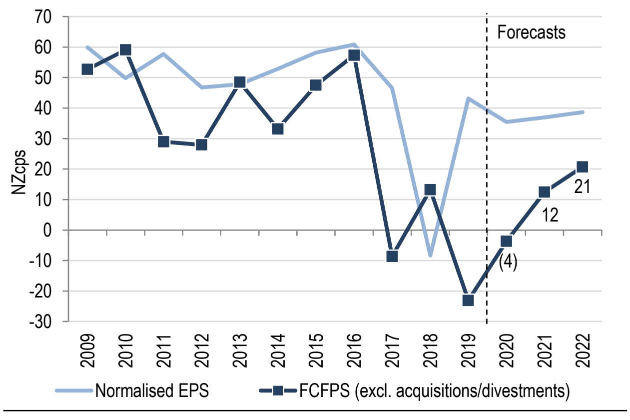
FBU is NZ's largest building materials and construction company. Operations include: (1) the manufacturing of a broad range of light and heavy building materials including cement, aggregates, concrete products, plasterboard, insulation and plastic pipes in NZ and Australia, (2) two global businesses 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%

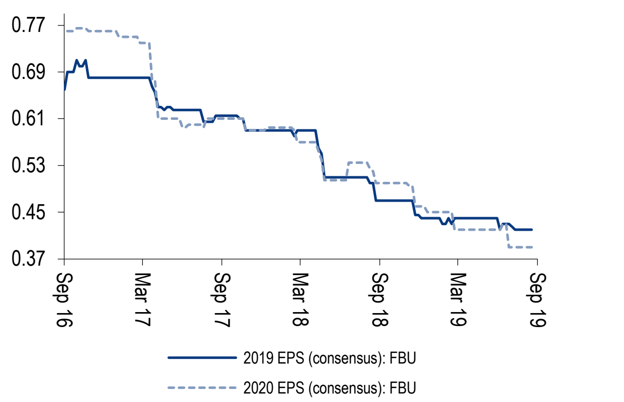
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 6. International Compcos

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
(metrics re-weighted to reflect FBU's balance date - June)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Fletcher Building	**FBU NZ**	**NZ$4.72**	**NZ$4,016**	**13.3x**	**12.8x**	**6.2x**	**6.0x**	**8.6x**	**8.7x**	**5.1%**
Metro Performance Glass *	MPG NZ	NZ$0.30	NZ$56	3.7x	4.1x	3.6x	4.0x	5.5x	6.2x	13.5%
Steel & Tube Holdings *	STU NZ	NZ$0.96	NZ$159	15.1x	13.5x	10.8x	10.5x	15.5x	14.5x	6.3%
Adelaide Brighton	ABC AT	A$3.15	A$2,053	15.8x	15.2x	9.1x	8.9x	13.1x	12.6x	4.8%
Boral	BLD AT	A$5.00	A$5,862	12.7x	12.2x	7.8x	7.6x	12.6x	12.3x	5.4%
CSR	CSR AT	A$4.04	A$2,012	14.2x	14.4x	7.4x	7.6x	10.0x	10.4x	5.5%
Dulux Group	DLX AT	A$9.35	A$3,639	24.6x	23.8x	15.6x	15.2x	17.7x	17.5x	3.1%
GWA Group	GWA AT	A$3.32	A$876	15.4x	14.6x	10.9x	10.4x	11.8x	11.3x	5.8%
James Hardie Industries PLC	JHX AT	US$15.71	US$6,948	19.2x	17.1x	13.0x	11.8x	16.6x	15.2x	3.4%
Reece	REH AT	A$10.22	A$5,732	21.4x	20.6x	10.4x	10.1x	12.5x	12.1x	2.2%
CRH PLC	CRH ID	€28.52	€22,731	12.8x	11.5x	7.1x	6.8x	11.0x	10.2x	2.9%
LafargeHolcim	LHN SW	CHF46.33	CHF28,536	12.5x	11.3x	6.2x	5.9x	10.0x	9.3x	4.5%
			Compco Average:	**15.2x**	**14.4x**	**9.3x**	**9.0x**	**12.4x**	**12.0x**	**5.2%**
EV = Current Market Cap + Actual Net Debt			**FBU Relative:**	**-12%**	**-11%**	**-34%**	**-33%**	**-31%**	**-28%**	**-2%**

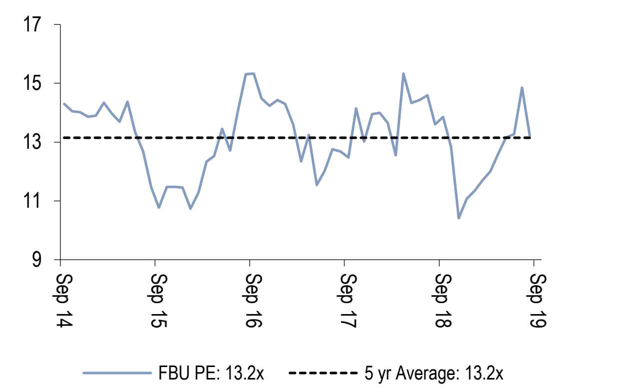
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (FBU) companies fiscal year end

Figure 7. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 8. 12 Month Forward PE



Source: Forsyth Barr analysis