

Fletcher Building

UNDERPERFORM

Pressures Reiterated

Fletcher Building's (FBU) initial FY20 guidance reemphasises that earnings remain pressured from a combination of competition, cost, easing NZ demand, and the Australian residential downturn. Guidance was modestly below our expectation, and looking through the balance of the fiscal year, we view risks as clearly down weighted. In our view, value remains insufficient to compensate for risks; maintain UNDERPERFORM.

What's changed?

- **Earnings:** EBIT FY20/21/22E -3%/-4%/-3%. (Our forecasts are not yet adjusted for IFRS 16.)

Guidance midpoint modestly below expectation

FBU's initial FY20 guidance of EBIT NZ\$515–565m includes a +NZ\$50m benefit from IFRS 16. Excluding this IFRS 16 impact, the midpoint of the NZ\$465–515m range was modestly below our prior NZ\$505m forecast (revised NZ\$489m), and our NZ\$512m estimate of FY19 normalised for one-off impacts.

There was little that surprised us in FBU's trading commentary:

- In NZ the performance of "core divisions" (Building Products, Concrete, Distribution) "remains on track against a solid market backdrop", underpinned by continued "strong" activity for residential and commercial finishing trades. Civil, infrastructure, and starting trades "is trending slightly lower as expected". The Residential division is benefiting from "strong" demand for housing and "supportive" prices and FBU expects it to deliver "slight" earnings growth yoy. "The steel market remains highly competitive".
- In Australia, the "cost-out programme is progressing to plan and there is good turnaround momentum in Laminex and Fletcher Insulation". "Intense competitor activity in the declining residential market is placing ongoing pressure on price and margin in Stramit and Tradelink, while infrastructure project delays are expected to have some near-term impact on Iplex and Rocla in FY20".

FBU expects Australian earnings "will be weighted to the 2H as benefits of the cost out programmes ramp up".

Risks remain negative

FBU's guidance reinforces the reasons for our concern. Despite ambitious cost-out objectives, earnings continue to slip under a combination of competition, cost, and demand pressures. We do not expect these to relent. In NZ infrastructure and larger scale commercial is moderating, and Australian residential work will fall further following the sharp decline in approvals. Our concern in Australia is exacerbated by (1) FBU's expectation that earnings will be 2H weighted, and (2) the likely sharp pending volume decline for its late-cycle businesses (Laminex, Tradelink). At FY20/21E FCF yields of -1%/+2% on peak-cycle NZ volumes we see insufficient value to compensate investors for these risks.

Investment View

We view the medium-term risks for FBU as negative from competitive, cost, and demand pressures. The stock's valuation "discount" vs. sector peers and the broader market masks weak free cash flow and peak cycle demand. UNDERPERFORM.

NZX Code	FBU
Share price	NZ\$5.17
Target price	NZ\$4.85
Risk rating	Medium
Issued shares	794.8m
Market cap	NZ\$4,109m
Average daily turnover	1,367k (NZ\$6,752k)

Share Price Performance



Average daily turnover 1,367k (NZ\$6,752k)

NPAT* (NZ\$m)	367.0	279.4	277.6	293.1
EPS* (NZc)	43.1	34.0	34.9	36.9
EPS growth* (%)	n/a	-21.3	2.8	5.6
DPS (NZc)	23.0	22.0	23.0	24.0
Imputation (%)	0	64	65	67

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	5.8	6.7	6.9	6.5
EV/EBIT	7.6	9.4	10.1	9.8
PE	12.0	15.2	14.8	14.0
Price / NTA	1.5	1.5	1.4	n/a
Cash dividend yield (%)	4.4	4.3	4.4	4.6
Gross dividend yield (%)	4.4	5.3	5.6	5.8

*Historic and forecast numbers based on underlying profits

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Fletcher Building (FBU)

Priced as at 28 Nov 2019: NZ\$5.17

June year end

Forsyth Barr valuation		Valuation Ratios					2018A	2019A	2020E	2021E	2022E
Valuation methodology	DCF, sector peer relative, mid-cycle	EV/EBITDA (x)	21.1	5.8	6.7	6.9	6.5				
		EV/EBIT (x)	>100x	7.6	9.4	10.1	9.8				
12-month target price (NZ\$)*	4.85	Spot valuations (NZ\$)	PE (x)	n/a	12.0	15.2	14.8	14.0			
Expected share price return	-6.2%	1. DCF	4.49	Price/NTA (x)	1.8	1.5	1.5	1.4	1.4		
Net dividend yield	4.3%	2. Sector peer relative	5.81	Free cash flow yield (%)	2.2	-4.7	-0.5	2.3	4.0		
Estimated 12-month return	-1.9%	3. Mid-cycle	4.02	Net dividend yield (%)	0.0	4.4	4.3	4.4	4.6		
				Gross dividend yield (%)	0.0	4.4	5.3	5.6	5.8		
Key WACC assumptions		DCF valuation summary (NZ\$m)		Imputation (%)	100	0	64	65	67		
Risk free rate	2.00%	Total firm value	3,995	Pay-out ratio (%)	0	53	65	66	65		
Equity beta	1.31	(Net debt)/cash	(325)								
WACC	8.8%	Value of equity	3,670	Capital Structure	2018A	2019A	2020E	2021E	2022E		
Terminal growth	2.0%	Shares (m)	795	Interest cover EBIT (x)	0.3	5.3	6.0	6.2	6.9		
				Interest cover EBITDA (x)	1.7	7.0	8.4	9.0	10.4		
				Net debt/ND+E (%)	23.6	7.3	18.2	19.2	19.3		
				Net debt/EBITDA (x)	4.8	0.4	1.3	1.4	1.3		
Profit and Loss Account (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Key Ratios	2018A	2019A	2020E	2021E	2022E
Sales revenue	9,471	9,307	8,007	8,043	8,169	Return on assets (%)	0.6	8.2	6.8	6.7	6.7
Normalised EBITDA	264	830	688	704	748	Return on equity (%)	-1.5	8.9	7.2	6.9	7.1
Depreciation and amortisation	(214)	(199)	(199)	(222)	(251)	Return on funds employed (%)	-1.1	8.8	7.1	6.7	6.7
Normalised EBIT	50	631	489	482	497	EBITDA margin (%)	2.8	8.9	8.6	8.8	9.2
Net interest	(157)	(118)	(82)	(78)	(72)	EBIT margin (%)	0.5	6.8	6.1	6.0	6.1
Associate income	-	-	-	-	-	Capex to sales (%)	3.2	3.7	4.8	5.0	4.8
Tax	58	(133)	(115)	(113)	(119)	Capex to depreciation (%)	142	175	195	182	156
Minority interests	11	13	13	13	13						
Normalised NPAT	(60)	367	279	278	293	Operating Performance	2018A	2019A	2020E	2021E	2022E
Abnormals/other	130	203	26	-	-	External revenue (NZ\$m)					
Reported NPAT	(190)	164	254	278	293	Concrete	545	549	569	579	589
Normalised EPS (cps)	(8.3)	43.1	34.0	34.9	36.9	Building Products	613	587	596	605	611
DPS (cps)	-	23.0	22.0	23.0	24.0	Distribution	1,490	1,552	1,644	1,696	1,709
						Steel	411	426	439	450	457
						Construction	1,605	1,622	1,301	1,280	1,312
						Residential and Land Development	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	8,007	8,043	8,169
Growth Rates	2018A	2019A	2020E	2021E	2022E	New Zealand	5,063	5,220	4,996	5,070	5,161
Revenue (%)	0.8	-1.7	-14.0	0.4	1.6	Australia	3,018	2,944	2,857	2,817	2,849
EBITDA (%)	-63.7	>100	-17.1	2.4	6.2	Rest of World	1,390	1,143	154	157	160
EBIT (%)	-90.5	>100	-22.5	-1.4	3.1	Total external revenue	9,471	9,307	8,007	8,043	8,169
Normalised NPAT (%)	n/a	n/a	-23.9	-0.7	5.6	EBIT (NZ\$m)					
Normalised EPS (%)	n/a	n/a	-21.3	2.8	5.6	Concrete	90	84	87	81	80
DPS (%)	-100.0	n/a	-4.3	4.5	4.3	Building Products	132	127	113	105	100
						Distribution	104	104	105	107	105
						Steel	49	33	26	32	38
						Construction	(608)	47	44	43	51
						Residential and Land Development	136	137	112	114	119
						Australia	114	57	59	55	62
						International	-	-	-	-	-
						Divested	78	82	-	-	-
						Other	(45)	(40)	(55)	(56)	(57)
Cash Flow (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Total EBIT	50	631	489	482	497
EBITDA	264	830	688	704	748	New Zealand	(180)	467	416	412	420
Working capital change	430	(404)	(184)	(14)	(2)	Australia	123	54	52	48	55
Interest & tax paid	(243)	(156)	(120)	(191)	(191)	Rest of World	107	110	21	21	22
Other	(55)	(117)	(15)	-	-	Total EBIT	50	631	489	482	497
Operating cash flow	396	153	368	499	554						
Capital expenditure	(304)	(348)	(387)	(405)	(390)						
(Acquisitions)/divestments	76	1,262	-	-	-						
Other	-	-	-	-	-						
Funding available/(required)	168	1,067	(19)	94	164						
Dividends paid	(123)	(68)	(193)	(175)	(183)						
Equity raised/(returned)	893	(81)	(300)	-	-						
Increase/(decrease) in net debt	(938)	(918)	512	81	18						
Balance Sheet (NZ\$m)	2018A	2019A	2020E	2021E	2022E						
Working capital	1,641	1,384	1,311	1,259	1,265						
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	5,113	5,243	5,388						
Net debt/(cash)	1,273	325	864	951	983						
Other non current liabilities	918	586	329	262	265						
Shareholder's funds	4,118	4,141	3,888	3,998	4,107						
Minority interests	24	32	32	32	32						
Total funding sources	6,333	5,084	5,113	5,243	5,388						

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

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

- **Limited medium-term free cash flow:** Forecast medium-term FCF yield: FY20/21/22E -1%/2%/4% reflecting crystallisation of construction losses and capex materially ahead of depreciation.
- **Strong balance sheet and capital management:** Proceeds from the sale of Formica have lowered FBU’s net debt to c.0.5x, significantly below its 1.5–2.5x EBITDA target. FBU is c.35% of the way through an “up to NZ\$300m” on-market buyback.

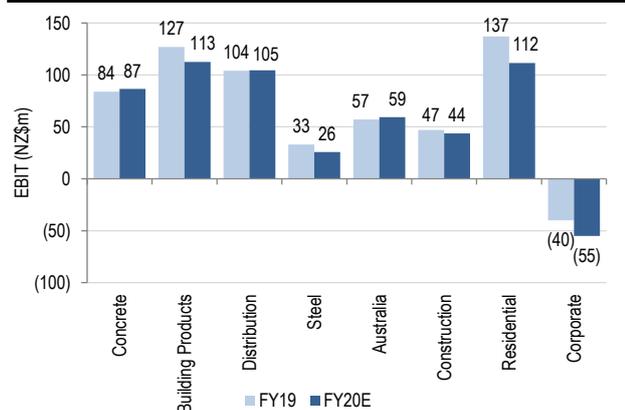
Risks factors

- **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 sink” 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

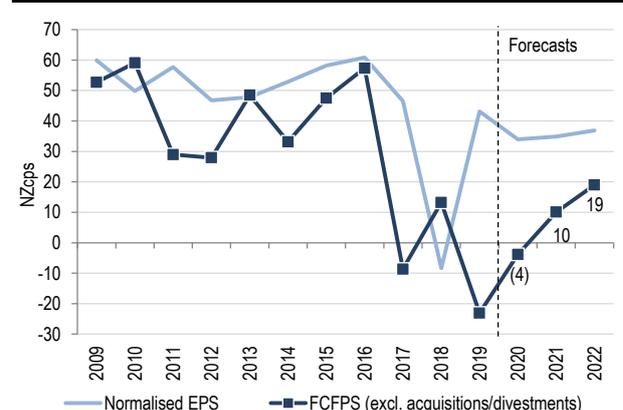
FBU is NZ’s largest building materials and construction company. Operations include: (1) the manufacturing of a broad range of light and heavy building materials including cement, aggregates, concrete products, plasterboard, insulation and plastic pipes in NZ and Australia, (2) two global businesses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



Source: Company reports, Forsyth Barr analysis

Figure 2. EPS and FCFPS



Source: Company reports, Forsyth Barr analysis

Figure 3. 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

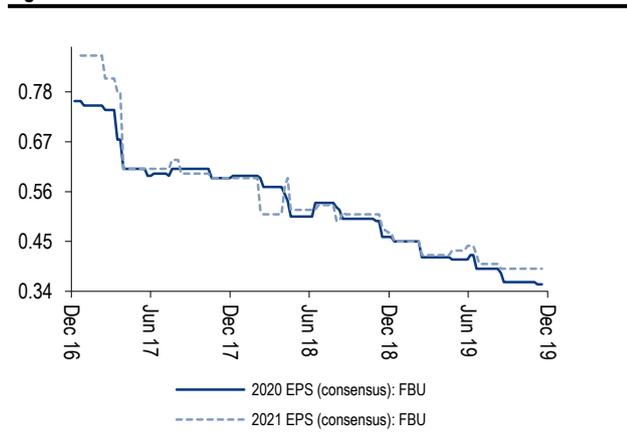
Figure 4. International Compcos

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
<i>(metrics re-weighted to reflect FBU's balance date - June)</i>										
			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Fletcher Building	FBU NZ	NZ\$5.17	NZ\$4,109	15.2x	14.8x	6.4x	6.3x	9.1x	9.2x	4.4%
Metro Performance Glass *	MPG NZ	NZ\$0.32	NZ\$59	4.9x	4.4x	3.2x	3.3x	5.7x	5.7x	12.7%
Steel & Tube Holdings *	STU NZ	NZ\$0.84	NZ\$139	14.2x	9.9x	6.7x	5.7x	10.2x	7.9x	7.1%
Adelaide Brighton	ABC AT	A\$3.38	A\$2,203	18.0x	17.4x	10.4x	10.1x	15.6x	15.0x	3.8%
Boral	BLD AT	A\$4.90	A\$5,744	14.2x	13.0x	7.6x	7.2x	13.3x	12.2x	4.9%
CSR	CSR AT	A\$4.65	A\$2,285	18.2x	17.3x	8.4x	8.4x	12.4x	12.5x	4.6%
Wagners Holding Co	WGN AT	A\$2.01	A\$376	31.4x	19.0x	13.2x	10.0x	21.7x	14.5x	2.3%
GWA Group	GWA AT	A\$3.40	A\$897	17.3x	16.3x	11.6x	11.1x	12.8x	12.2x	5.4%
James Hardie Industries PLC	JHX AT	US\$19.77	US\$8,744	23.3x	20.8x	15.7x	14.3x	19.7x	18.0x	2.7%
Reece	REH AT	A\$10.30	A\$5,776	22.8x	20.8x	13.3x	12.5x	17.1x	15.8x	2.2%
CRH PLC	CRH ID	€35.06	€27,713	15.8x	14.5x	9.0x	8.7x	14.3x	13.4x	2.3%
LafargeHolcim	LHN SW	CHF52.16	CHF32,127	14.1x	13.0x	6.9x	6.7x	10.8x	10.3x	4.0%
Compcio Average:				17.7x	15.1x	9.6x	8.9x	13.9x	12.5x	4.7%
FBU Relative:				-14%	-2%	-33%	-29%	-35%	-26%	-6%

EV = Current Market Cap + Actual Net Debt

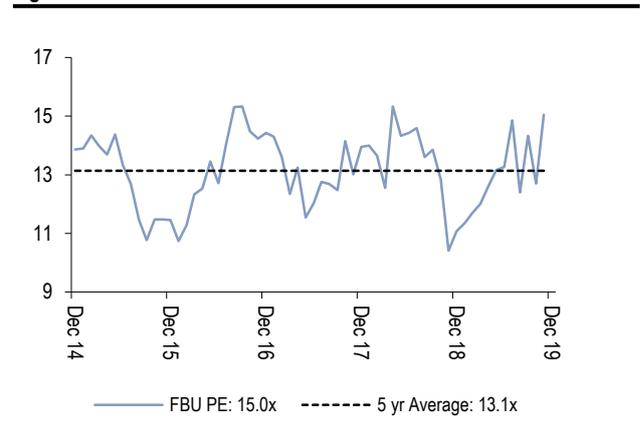
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compcio metrics re-weighted to reflect headline (FBU) companies fiscal year end

Figure 5. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 6. 12 Month Forward PE



Source: Forsyth Barr analysis

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