NEW ZEALAND EQUITY RESEARCH | BUILDING | BUILDING CONGLOMERATE
18 FEBRUARY 2020

Fletcher Building
1H20 Preview — Grinding Lower

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UNDERPERFORM

Fletcher Building (FBU) reports its 1H20 result on 19 February — on a like-for-like basis we expect earnings to remain under pressure from (1) cost inflation in NZ, (2) softer construction activity in Australia, and (3) competition impacts on share and margins in both markets. Whilst we believe it is too early in the year for FBU to consider a revision to its NZ $515–565m EBIT guidance, we suspect market expectations may drift toward the lower end of this range.

NZX Code	FBU
Share price	NZ$5.23
Target price	NZ$4.85
Risk rating	Medium
Issued shares	799.3m
Market cap	NZ$4,181m
Avg daily turnover	1,304k (NZ$6,510k)

Financials: Jun/	19A	20E	21E	22E
NPAT* (NZ$m)	367.0	268.2	266.2	285.3
EPS* (NZc)	43.1	32.5	33.3	35.7
EPS growth* (%)	n/a	-24.7	2.4	7.2
DPS (NZc)	23.0	23.0	23.0	25.0
Imputation (%)	0	65	65	64

*Based on normalised profits

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	5.9	5.1	5.3	5.0
EV/EBIT	7.7	8.7	9.3	9.0
PE	12.1	16.1	15.7	14.7
Price / NTA	1.5	1.7	1.6	1.6
Cash div yld (%)	4.4	4.4	4.4	4.8
Gross div yld (%)	4.4	5.5	5.5	6.0

Key issues to watch for:

- **Underlying earnings decline:** Despite ongoing ambitious cost-out objectives and robust NZ building activity, we forecast like-for-like EBIT (excluding divested assets, property sales, and IFRS 16 accounting impacts) to fall -13% on:

    1. Cost inflation in NZ, including from the higher minimum wage, fuel tax hikes, regulatory and compliance costs, and investment in capacity expansion. The reversal of negative impacts on 1H19 — an unplanned outage at Golden Bay Cement costing NZ$7m and an NZ$(5)m EBIT loss for NZ Construction — will provide some offset.
    2. Softer construction activity in Australia. FBU has already stated it expects Australian earnings to be "weighted to the 2H as benefits of the cost out programmes ramp up". Bush fires would not have helped either.
    3. Competitive impacts on share and margins, most notably in Stramit and Tradelink in Australia, and Steel in NZ.

- **Weak free cash flow:** We expect FBU's free cash flow to remain limited given crystallisation of previous construction losses, capex materially ahead of depreciation, and possible investment in residential development land.
- **Too early for guidance revision:** Whilst we believe FBU's 1H20 may disappoint some, we do not anticipate any guidance revision at this time. Typically at this time of year it is too early for a clear picture of new year demand trends. Furthermore, anecdotes suggest favourable weather in NZ has supported activity in recent months which should underpin optimism for the 2H ahead.

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: 6365628. Webcast: https://edge.media-server.com/mmc/p/8iccqsap

Figure 1. FBU 1H20E forecasts

NZ$m	1H19	1H20E	% chg
Revenue	4,185	4,013	-4.1%
EBIT	285	246	-13.6%
Underlying profit	160	122	-24.0%
Underlying EPS (cps)	22.2	16.8	-24.0%
Dividend (cps)	8.0	8.0	0.0%

Source: Company results, Forsyth Barr analysis

Fletcher Building (FBU)

Priced as at 17 Feb 2020 (NZ$)	**5.23**

12-month target price (NZ$)*	**4.85**
Expected share price return	-7.3%
Net dividend yield	4.4%
Estimated 12-month return	-2.9%

Spot valuations (NZ$)	
1. DCF	4.16
2. Sector peer relative	4.99
3. Mid-cycle	4.02

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	1.31
WACC	8.8%
Terminal growth	2.0%

DCF valuation summary (NZ$m)	
Total firm value	5,465
(Net debt)/cash	(325)
Less: Capitalised operating leases	(1,818)
Value of equity	3,322

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	9,471.0	9,307.0	8,001.2	8,036.9	8,198.5
Normalised EBITDA	**264.0**	**830.0**	**923.6**	**940.7**	**990.2**
Depreciation and amortisation	(214.0)	(199.0)	(383.9)	(407.5)	(436.4)
Normalised EBIT	**50.0**	**631.0**	**539.7**	**533.2**	**553.8**
Net interest	(157.0)	(118.0)	(146.3)	(142.9)	(137.5)
Associate income	0	0	0	0	0
Tax	58.0	(133.0)	(110.8)	(109.3)	(116.6)
Minority interests	11.0	13.0	14.4	14.8	14.5
Normalised NPAT	**(60.0)**	**367.0**	**268.2**	**266.2**	**285.3**
Abnormals/other	(130.0)	(203.0)	(25.5)	0	0
Reported NPAT	**(190.0)**	**164.0**	**242.7**	**266.2**	**285.3**
Normalised EPS (cps)	(8.3)	43.1	32.5	33.3	35.7
DPS (cps)	0	23.0	23.0	23.0	25.0

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	21.3	5.9	5.1	5.3	5.0
EV/EBIT (x)	>100x	7.7	8.7	9.3	9.0
PE (x)	n/a	12.1	16.1	15.7	14.7
Price/NTA (x)	1.8	1.5	1.7	1.6	1.6
Free cash flow yield (%)	2.2	-4.7	1.3	4.9	6.6
Net dividend yield (%)	0.0	4.4	4.4	4.4	4.8
Gross dividend yield (%)	0.0	4.4	5.5	5.5	6.0

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	0.3	5.3	3.7	3.7	4.0
Interest cover EBITDA (x)	1.7	7.0	6.3	6.6	7.2
Net debt/ND+E (%)	23.6	7.3	20.1	21.3	21.5
Net debt/EBITDA (x)	4.8	0.4	1.0	1.1	1.0

Growth Rates	**2018A**	**2019A**	**2020A**	**2021A**	**2022A**
Revenue (%)	0.8	-1.7	-14.0	0.4	2.0
EBITDA (%)	-63.7	>100	11.3	1.8	5.3
EBIT (%)	-90.5	>100	-14.5	-1.2	3.9
Normalised NPAT (%)	n/a	n/a	-26.9	-0.8	7.2
Normalised EPS (%)	n/a	n/a	-24.7	2.4	7.2
Ordinary DPS (%)	-100.0	n/a	0.0	0.0	8.7

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	0.6	8.2	6.2	6.1	6.3
Return on equity (%)	-1.5	8.9	7.5	7.3	7.6
Return on funds employed (%)	-1.1	8.8	7.7	7.5	7.6
EBITDA margin (%)	2.8	8.9	11.5	11.7	12.1
EBIT margin (%)	0.5	6.8	6.7	6.6	6.8
Capex to sales (%)	3.2	3.7	4.8	5.0	4.8
Capex to depreciation (%)	142	175	101	99	89
Imputation (%)	100	0	65	65	64
Pay-out ratio (%)	0	53	71	69	70

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**264.0**	**830.0**	**923.6**	**940.7**	**990.2**
Working capital change	430.0	(404.0)	(224.1)	(14.4)	(3.0)
Interest & tax paid	(243.0)	(156.0)	(244.9)	(317.1)	(319.5)
Other	(55.0)	(117.0)	(15.0)	0	0
Operating cash flow	**396.0**	**153.0**	**439.7**	**609.2**	**667.7**
Capital expenditure	(304.0)	(348.0)	(387.0)	(405.0)	(390.0)
(Acquisitions)/divestments	76.0	1,262.0	0	0	0
Other	0	0	(169.8)	(171.4)	(172.9)
Funding available/(required)	**168.0**	**1,067.0**	**(117.2)**	**32.7**	**104.8**
Dividends paid	(123.0)	(68.0)	(193.6)	(183.8)	(191.8)
Equity raised/(returned)	893.0	(81.0)	(300.0)	0	0
(Increase)/decrease in net debt	**938.0**	**918.0**	**(610.8)**	**(151.1)**	**(87.1)**

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
External revenue (NZ$m)					
New Zealand	5,063	5,220	4,990	5,063	5,190
Australia	3,018	2,944	2,857	2,817	2,849
Rest of World	1,390	1,143	154	157	160
Total external revenue	**9,471**	**9,307**	**8,001**	**8,037**	**8,199**
EBIT (NZ$m)					
Concrete	90	84	87	81	83
Building Products	132	127	124	117	113
Distribution	104	104	116	119	116
Steel	49	33	28	34	40
Construction	(608)	47	48	47	56
Residential / Land Developm't	136	137	112	114	119
Australia	114	57	79	75	82
Divested	78	82	0	0	0
Corporate / other	(45)	(40)	(53)	(54)	(55)
Total EBIT	**50**	**631**	**540**	**533**	**554**
EBIT (NZ$m)					
New Zealand	(180)	467	447	444	457
Australia	123	54	72	68	75
Rest of World	9,528	8,786	7,482	7,525	7,666
Total EBIT	**9,471**	**9,307**	**8,001**	**8,037**	**8,199**

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	1,641.0	1,384.0	1,351.1	1,298.3	1,307.9
Fixed assets	2,231.0	1,754.0	1,927.2	2,110.2	2,249.5
Intangibles	1,696.0	1,129.0	1,129.0	1,129.0	1,129.0
Right of use asset	0	0	1,502.4	1,504.7	1,507.1
Other assets	765.0	817.0	745.0	745.0	745.0
Total funds employed	**6,333.0**	**5,084.0**	**6,654.7**	**6,787.2**	**6,938.5**
Net debt/(cash)	1,273.0	325.0	899.7	993.6	1,030.1
Lease liability	0	0	1,817.7	1,834.0	1,849.2
Other liabilities	918.0	586.0	329.0	261.8	268.4
Shareholder's funds	4,118.0	4,141.0	3,576.3	3,665.8	3,758.7
Minority interests	24.0	32.0	32.0	32.0	32.0
Total funding sources	**6,333.0**	**5,084.0**	**6,654.7**	**6,787.2**	**6,938.5**

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

Earnings forecasts

Figure 2. 1H20E earnings forecasts

NZ$m	1H19	1H20E	% chg
Revenue	**4,185**	**4,013**	**-4.1%**
EBIT			
Concrete	42	43	2.4%
Building Products	66	64	-3.5%
Distribution	50	56	11.4%
Steel	21	8	-60.4%
Construction	15	17	11.1%
Residential and Land Development	43	56	29.8%
Australia	33	30	-8.6%
Divested	37	0	-100.0%
Other	(22)	(27)	22.9%
EBIT (before significant items)	**285**	**246**	**-13.6%**
EBIT (excl. IFRS 16 and divestments)	**248**	**222**	**-10.6%**
Significant items (before tax)	(68)	(30)	-55.9%
EBIT	**217**	**216**	**-0.3%**
Interest	(62)	(72)	16.3%
Net profit before tax	**155**	**144**	**-7.0%**
Tax	(61)	(42)	-30.9%
Net profit after tax	**94**	**102**	**8.5%**
Minorities	(5)	(6)	19.1%
Reported profit	**89**	**96**	**8.0%**
Underlying profit	**160**	**122**	**-24.0%**
Underlying EPS (cps)	22.2	16.8	-24.0%
Dividend (cps)	8.0	8.0	0.0%
Geographical EBIT			
New Zealand	195	177	-9.3%
Australia	32	33	3.1%
Rest of world	18	12	-33.3%

Source: Company results, Forsyth Barr analysis

FORSYTH BARR

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.

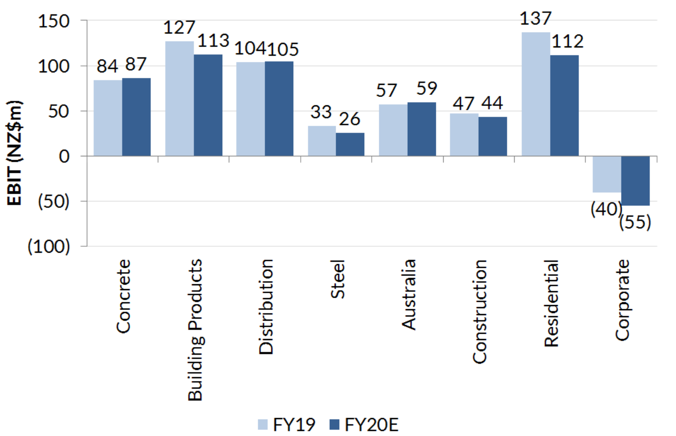
Earnings and cashflow outlook

- **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.

Risk factors

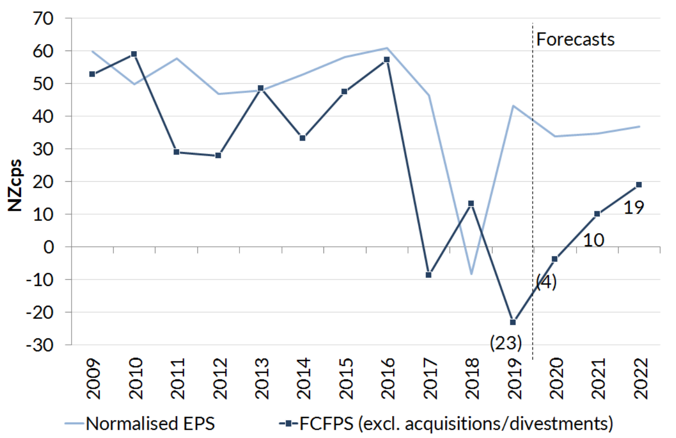
- **Construction cycles in NZ and Australia:** FBU is levered to cyclical construction activity in NZ and AU, weighted to residential in both markets.
- **Competitive pressures:** Competition and cost inflation could materially influence FBU's market share and margins.
- **Construction losses:** Consensus 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.

Figure 3. Divisional EBIT



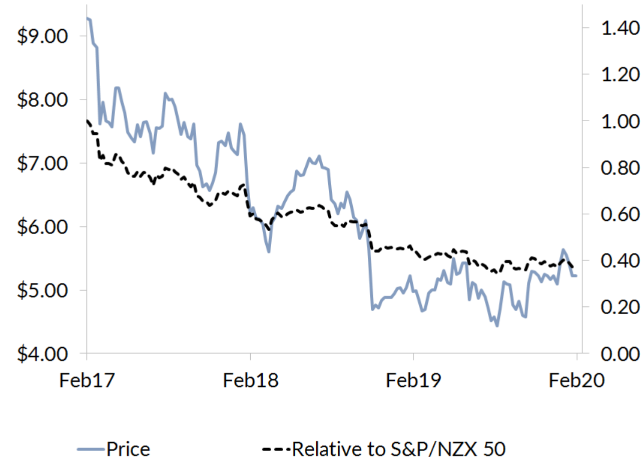
Source: Company reports, Forsyth Barr analysis

Figure 4. EPS and FCFPS



Source: Company reports, Forsyth Barr analysis

Figure 5. Price performance



Source: Forsyth Barr analysis

Figure 6. Substantial shareholders

Shareholder	Latest Holding
Perpetual	11.2%
Schroder Investment Management Group	8.3%
Commonwealth Bank of Australia	6.0%
The Vanguard Group	5.6%

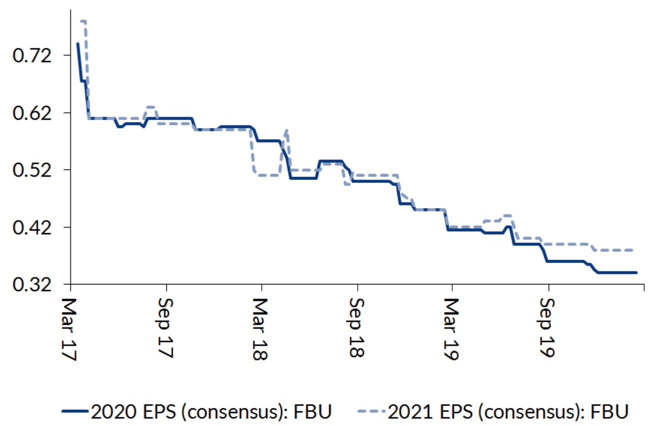
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 7. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect FBU's balance date - June)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Fletcher Building	**FBU NZ**	**NZ$5.23**	**NZ$4,181**	**16.1x**	**15.7x**	**4.9x**	**4.8x**	**8.3x**	**8.5x**	**4.4%**
Metro Performance Glass *	MPG NZ	NZ$0.25	NZ$46	3.9x	3.4x	2.9x	3.0x	5.2x	5.2x	16.3%
Steel & Tube Holdings *	STU NZ	NZ$0.81	NZ$134	25.3x	11.3x	4.1x	3.5x	9.3x	6.4x	6.2%
Adelaide Brighton	ABC AT	A$3.20	A$2,086	17.3x	16.8x	9.8x	9.7x	14.7x	14.3x	4.0%
Boral	BLD AT	A$4.72	A$5,533	15.8x	14.1x	7.8x	7.3x	14.8x	13.3x	4.6%
CSR	CSR AT	A$4.89	A$2,403	19.2x	17.9x	8.7x	8.6x	12.9x	12.8x	4.3%
Wagners Holding Co	WGN AT	A$1.91	A$358	28.1x	15.4x	12.2x	8.7x	19.3x	12.2x	2.8%
GWA Group	GWA AT	A$3.90	A$1,029	19.9x	18.9x	13.1x	12.6x	14.4x	13.8x	4.6%
James Hardie Industries PLC	JHX AT	US$20.53	US$9,095	24.3x	21.5x	16.3x	14.6x	20.3x	17.9x	2.6%
Reece	REH AT	A$11.49	A$6,444	26.5x	23.9x	14.6x	13.6x	19.1x	17.6x	2.0%
CRH PLC	CRH ID	€35.77	€28,158	15.9x	14.6x	9.1x	8.8x	14.3x	13.5x	2.3%
LafargeHolcim	LHN SW	CHF49.70	CHF30,612	13.6x	12.6x	6.6x	6.4x	10.5x	9.9x	4.3%
			Compco Average:	**19.1x**	**15.5x**	**9.6x**	**8.8x**	**14.1x**	**12.4x**	**4.9%**
EV = Current Market Cap + Actual Net Debt			**FBU Relative:**	**-16%**	**1%**	**-49%**	**-46%**	**-41%**	**-32%**	**-10%**

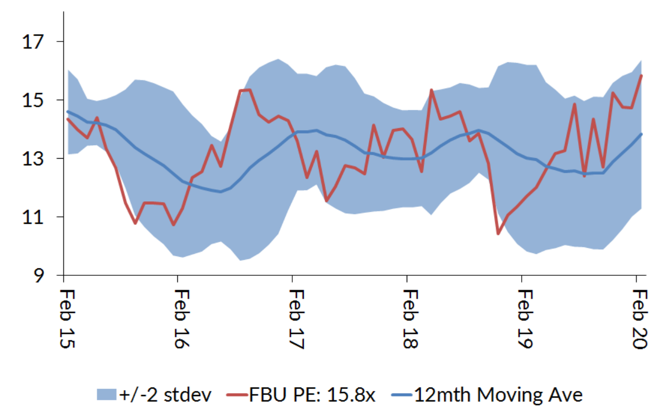
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (FBU) companies fiscal year end

Figure 8. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 9. One year forward PE (x)



Source: Forsyth Barr analysis

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