

# Fletcher Building

## 1H20 – Ebbing, Not Flowing

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### UNDERPERFORM

Fletcher Building's (FBU) earnings continue to decline, understandably in Australia given the construction weakness, but also in NZ as competitive and cost pressures continue to impact. Cash flow remains negative. FY20 guidance was maintained, albeit helped by higher land sales gains and lower depreciation. There is no change to our investment view – we see a business that continues to ebb backward, without sufficient value to compensate. Maintain UNDERPERFORM.

NZX Code	FBU	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$5.41	NPAT* (NZ\$m)	367.0	266.9	254.2	270.2	EV/EBITDA	6.0	5.4	5.6	5.3
Target price	NZ\$4.85	EPS* (NZc)	43.1	32.4	31.9	33.9	EV/EBIT	7.9	9.2	10.0	9.6
Risk rating	Medium	EPS growth* (%)	n/a	-24.9	-1.6	6.3	PE	12.5	16.7	17.0	16.0
Issued shares	797.2m	DPS (NZc)	23.0	24.0	23.0	24.0	Price / NTA	1.5	1.8	1.7	1.7
Market cap	NZ\$4,313m	Imputation (%)	0	54	65	67	Cash div yld (%)	4.3	4.4	4.3	4.4
Avg daily turnover	1,317k (NZ\$6,577k)	*Based on normalised profits					Gross div yld (%)	4.3	5.4	5.3	5.6

### New Zealand remains under pressure despite buoyant construction backdrop

Whilst the headline 1H20 numbers (NZ EBIT down -22% excl. IFRS 16 impacts) overstates the magnitude of the trend, FBU's NZ earnings continue to go backward, despite robust construction activity, under pressure from competition and cost. [Every NZ division reported an underlying EBIT decline](#) except Concrete, which was only positive because of NZ\$7m of one-off costs from the Golden Bay Cement outage in the pcp. Earnings in Residential and Construction can be inherently variable, and FBU expects improvements in the 2H. What is not open for interpretation is that NZ earnings have been declining for 3 years despite a healthy demand backdrop.

### Australia unsurprisingly challenging

Underlying Australia EBIT fell -19%, unsurprising given weakened market demand. Easing resin and oil prices would have provided some benefit. FBU expects cost savings to provide a significant boost to 2H earnings. We are less convinced given FBU's late-cycle and high operating leverage businesses (Laminex, Tradelink) will likely face challenges from further volume declines.

### No free cash flow

FBU's cash flows remain negative (NZ\$(211)m in the period) due to crystallisation of construction losses, and capex materially ahead of depreciation. Free cash flow is likely to remain limited. FBU announced the c.NZ\$400m development of a new plasterboard factory over the next 2–3 years, on top of already elevated capex.

### FY20 guidance maintained (with a little help)

Unchanged at EBIT NZ\$515–565m, helped by higher land sales gains (guidance up NZ\$10m+) and lower depreciation (guidance down NZ\$10–20m). FBU expects a large 2H earnings skew driven by (1) improved performances from NZ Steel and Australia, (2) a strong pipeline of Residential housing settlements, and (3) a 2H weighting to Construction.

We have revised FY20/21/22E EBIT down by -4%/-4%/-4% on market share pressures across the NZ businesses, and sit toward the bottom end of the guidance range. We see downside risk. The impact on NPAT is muted by a lower effective tax rate.

**Fletcher Building (FBU)**

Priced as at 19 Feb 2020 (NZ\$)

**5.41**
**12-month target price (NZ\$)\***
**4.85**

Expected share price return	-10.4%
Net dividend yield	4.3%
Estimated 12-month return	-6.0%

**Spot valuations (NZ\$)**

1. DCF	3.93
2. Sector peer relative	4.33
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	5,278
(Net debt)/cash	(325)
Less: Capitalised operating leases	(1,823)
Value of equity	3,130

<b>Profit and Loss Account (NZ\$m)</b>	2018A	2019A	2020E	2021E	2022E	<b>Valuation Ratios</b>	2018A	2019A	2020E	2021E	2022E
Sales revenue	9,471.0	9,307.0	7,998.4	8,013.5	8,176.4	EV/EBITDA (x)	21.8	6.0	5.4	5.6	5.3
<b>Normalised EBITDA</b>	<b>264.0</b>	<b>830.0</b>	<b>890.7</b>	<b>919.9</b>	<b>970.5</b>	EV/EBIT (x)	>100x	7.9	9.2	10.0	9.6
Depreciation and amortisation	(214.0)	(199.0)	(369.7)	(408.5)	(437.3)	PE (x)	n/a	12.5	16.7	17.0	16.0
<b>Normalised EBIT</b>	<b>50.0</b>	<b>631.0</b>	<b>521.0</b>	<b>511.5</b>	<b>533.2</b>	Price/NTA (x)	1.9	1.5	1.8	1.7	1.7
Net interest	(157.0)	(118.0)	(145.0)	(143.5)	(143.4)	Free cash flow yield (%)	2.1	-4.5	0.9	4.2	5.9
Associate income	0	0	0	0	0	Net dividend yield (%)	0.0	4.3	4.4	4.3	4.4
Tax	58.0	(133.0)	(98.7)	(103.0)	(109.2)	Gross dividend yield (%)	0.0	4.3	5.4	5.3	5.6
Minority interests	11.0	13.0	10.4	10.7	10.4						
<b>Normalised NPAT</b>	<b>(60.0)</b>	<b>367.0</b>	<b>266.9</b>	<b>254.2</b>	<b>270.2</b>	<b>Capital Structure</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
Abnormals/other	(130.0)	(203.0)	(25.0)	0	0	Interest cover EBIT (x)	0.3	5.3	3.6	3.6	3.7
<b>Reported NPAT</b>	<b>(190.0)</b>	<b>164.0</b>	<b>241.9</b>	<b>254.2</b>	<b>270.2</b>	Interest cover EBITDA (x)	1.7	7.0	6.1	6.4	6.8
Normalised EPS (cps)	(8.3)	43.1	32.4	31.9	33.9	Net debt/ND+E (%)	23.6	7.3	20.6	21.7	21.9
DPS (cps)	0	23.0	24.0	23.0	24.0	Net debt/EBITDA (x)	4.8	0.4	1.0	1.1	1.1
<b>Growth Rates</b>	<b>2018A</b>	<b>2019A</b>	<b>2020A</b>	<b>2021A</b>	<b>2022A</b>	<b>Key Ratios</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
Revenue (%)	0.8	-1.7	-14.1	0.2	2.0	Return on assets (%)	0.6	8.2	6.0	5.9	6.0
EBITDA (%)	-63.7	>100	7.3	3.3	5.5	Return on equity (%)	-1.5	8.9	7.5	7.0	7.2
EBIT (%)	-90.5	>100	-17.4	-1.8	4.3	Return on funds employed (%)	-1.1	8.8	7.7	7.1	7.2
Normalised NPAT (%)	n/a	n/a	-27.3	-4.8	6.3	EBITDA margin (%)	2.8	8.9	11.1	11.5	11.9
Normalised EPS (%)	n/a	n/a	-24.9	-1.6	6.3	EBIT margin (%)	0.5	6.8	6.5	6.4	6.5
Ordinary DPS (%)	-100.0	n/a	4.3	-4.2	4.3	Capex to sales (%)	3.2	3.7	4.8	5.1	4.8
						Capex to depreciation (%)	142	175	105	99	89
<b>Cash Flow (NZ\$m)</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>	Imputation (%)	100	0	54	65	67
<b>EBITDA</b>	<b>264.0</b>	<b>830.0</b>	<b>890.7</b>	<b>919.9</b>	<b>970.5</b>	Pay-out ratio (%)	0	53	74	72	71
Working capital change	430.0	(404.0)	(218.2)	(14.9)	(3.3)						
Interest & tax paid	(243.0)	(156.0)	(231.5)	(317.1)	(323.9)	<b>Operating Performance</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
Other	(55.0)	(117.0)	(15.0)	0	0	<b>External revenue (NZ\$m)</b>					
<b>Operating cash flow</b>	<b>396.0</b>	<b>153.0</b>	<b>426.0</b>	<b>587.9</b>	<b>643.3</b>	New Zealand	5,063	5,220	4,987	5,040	5,168
Capital expenditure	(304.0)	(348.0)	(387.0)	(405.0)	(390.0)	Australia	3,018	2,944	2,857	2,817	2,849
(Acquisitions)/divestments	76.0	1,262.0	0	0	0	Rest of World	1,390	1,143	154	157	160
Other	0	0	(164.7)	(166.7)	(168.6)	<b>Total external revenue</b>	<b>9,471</b>	<b>9,307</b>	<b>7,998</b>	<b>8,014</b>	<b>8,176</b>
<b>Funding available/(required)</b>	<b>168.0</b>	<b>1,067.0</b>	<b>(125.8)</b>	<b>16.1</b>	<b>84.7</b>						
Dividends paid	(123.0)	(68.0)	(218.3)	(167.4)	(183.4)	<b>EBIT (NZ\$m)</b>					
Equity raised/(returned)	893.0	(81.0)	(300.0)	0	0	Concrete	90	84	92	86	88
<b>(Increase)/decrease in net debt</b>	<b>938.0</b>	<b>918.0</b>	<b>(644.0)</b>	<b>(151.3)</b>	<b>(98.7)</b>	Building Products	132	127	124	117	113
						Distribution	104	104	105	108	105
<b>Balance Sheet (NZ\$m)</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>	Steel	49	33	13	24	29
Working capital	1,641.0	1,384.0	1,345.2	1,293.0	1,302.9	Construction	(608)	47	45	45	54
Fixed assets	2,231.0	1,754.0	1,936.5	2,118.5	2,256.9	Residential / Land Developm't	136	137	117	113	119
Intangibles	1,696.0	1,129.0	1,129.0	1,129.0	1,129.0	Australia	114	57	79	75	82
Right of use asset	0	0	1,502.4	1,504.7	1,507.1	Divested	78	82	0	0	0
Other assets	765.0	817.0	745.0	745.0	745.0	Corporate / other	(45)	(40)	(55)	(56)	(57)
<b>Total funds employed</b>	<b>6,333.0</b>	<b>5,084.0</b>	<b>6,658.1</b>	<b>6,790.2</b>	<b>6,940.9</b>	<b>Total EBIT</b>	<b>50</b>	<b>631</b>	<b>521</b>	<b>511</b>	<b>533</b>
Net debt/(cash)	1,273.0	325.0	923.4	1,007.7	1,045.9						
Lease liability	0	0	1,822.8	1,843.8	1,863.3	<b>EBIT (NZ\$m)</b>					
Other liabilities	918.0	586.0	329.0	261.8	268.4	New Zealand	(180)	467	428	422	437
Shareholder's funds	4,118.0	4,141.0	3,550.9	3,644.9	3,731.3	Australia	123	54	72	68	75
Minority interests	24.0	32.0	32.0	32.0	32.0	Rest of World	9,528	8,786	7,498	7,523	7,665
<b>Total funding sources</b>	<b>6,333.0</b>	<b>5,084.0</b>	<b>6,658.1</b>	<b>6,790.2</b>	<b>6,940.9</b>	<b>Total EBIT</b>	<b>9,471</b>	<b>9,307</b>	<b>7,998</b>	<b>8,014</b>	<b>8,176</b>

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

## Result analysis

### Earnings revisions

Figure 1. 1H20 financials

NZ\$m	1H19	1H19 pro forma	1H20	% chg	% chg vs. pro forma	Forbar	% diff
<b>External revenue</b>							
Concrete	275		273	-0.7%		282	-3.2%
Building Products (incl. Steel)	520		507	-2.5%		523	-3.0%
Distribution	786		805	2.4%		836	-3.7%
Construction	842		742	-11.9%		657	12.9%
Residential and Land Development	251		224	-10.8%		255	-12.1%
Australia	1,511		1,410	-6.7%		1,460	-3.4%
Divested	569		0	n.a.		0	n.a.
<b>Total revenue</b>	<b>4,754</b>		<b>3,961</b>	<b>-16.7%</b>		<b>4,013</b>	<b>-1.3%</b>
<b>EBIT</b>							
Concrete	42	44	49	16.7%	11.4%	43	13.9%
Building Products	66	69	65	-1.5%	-5.8%	64	2.1%
Distribution	50	55	50	0.0%	-9.1%	56	-10.3%
Steel	21	22	1	-95.2%	-95.5%	8	-88.0%
Construction	15	17	14	-6.7%	-17.6%	17	-16.0%
Residential and Land Development	43	43	35	-18.6%	-18.6%	56	-37.3%
Australia	33	43	35	6.1%	-18.6%	30	16.0%
Other	(22)	(21)	(30)	36.4%	42.9%	(27)	11.0%
<b>EBIT (before significant items)</b>	<b>248</b>	<b>272</b>	<b>219</b>	<b>-11.7%</b>	<b>-19.5%</b>	<b>246</b>	<b>-11.1%</b>
Divestments	37	37	0	n.a.	n.a.	0	n.a.
Significant items (before tax)	(68)	(68)	(35)	-48.5%	-48.5%	(30)	16.7%
<b>EBIT</b>	<b>217</b>	<b>241</b>	<b>184</b>	<b>-15.2%</b>	<b>-23.7%</b>	<b>216</b>	<b>-14.9%</b>
Interest	(62)		(70)	12.9%		(72)	-2.9%
<b>Net profit before tax</b>	<b>155</b>		<b>114</b>	<b>-26.5%</b>		<b>144</b>	<b>-20.9%</b>
Tax	(61)		(28)	-54.1%		(42)	-33.6%
<b>Net profit after tax</b>	<b>94</b>		<b>86</b>	<b>-8.5%</b>		<b>102</b>	<b>-15.7%</b>
Minorities	(5)		(4)	-20.0%		(6)	-32.9%
<b>Reported profit</b>	<b>89</b>		<b>82</b>	<b>-7.9%</b>		<b>96</b>	<b>-14.7%</b>
<b>Underlying profit</b>	<b>160</b>		<b>107</b>	<b>-33.1%</b>		<b>122</b>	<b>-12.0%</b>
Underlying EPS (cps)	22.2		14.8	-33.1%		16.8	-12.0%
Dividend (cps)	8.0		11.0	37.5%		8.0	37.5%
<b>Geographical revenue</b>							
New Zealand	2,600		2,472	-4.9%		2,480	-0.3%
Australia	1,522		1,428	-6.2%		1,460	-2.2%
Rest of world	632		61	-90.3%		73	-16.9%
<b>Geographical EBIT</b>							
New Zealand	195	212	166	-14.9%	-21.7%	206	-19.3%
Australia	32	42	44	37.5%	4.8%	30	45.9%
Rest of world	18	18	9	-50.0%	-50.0%	10	-13.9%

Source: Forsyth Barr analysis

**Figure 2. Earnings revisions**

NZ\$m	FY20E			FY21E			FY22E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Revenue	8,001	7,998	0.0%	8,037	8,014	-0.3%	8,199	8,176	-0.3%
EBITDA	924	891	-3.6%	941	920	-2.2%	990	971	-2.0%
EBIT	540	521	-3.5%	533	511	-4.1%	554	533	-3.7%
Underlying NPAT	268	267	-0.5%	266	254	-4.5%	285	270	-5.3%
Underlying EPS (cps)	32.5	32.4	-0.4%	33.3	31.9	-4.2%	35.7	33.9	-5.0%
Dividend (cps)	23.0	24.0	4.3%	23.0	23.0	0.0%	25.0	24.0	-4.0%

Source: 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.

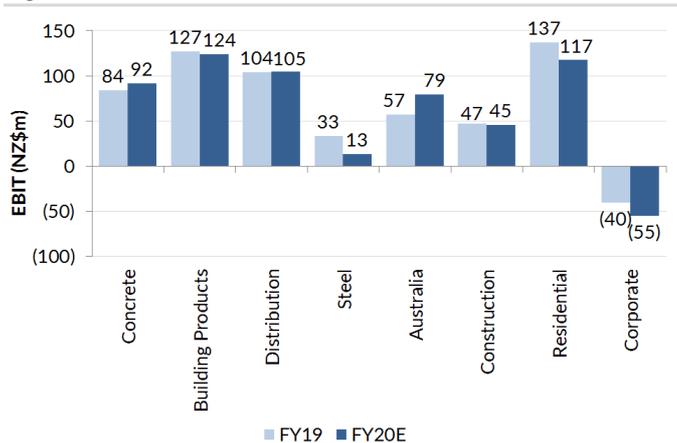
### Earnings and cashflow outlook

- **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

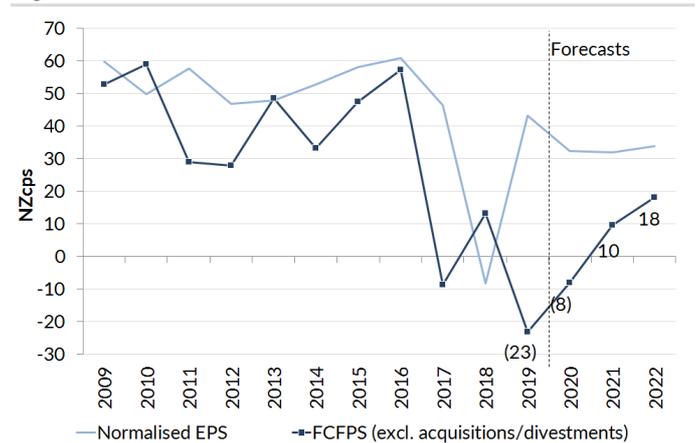
- **Construction cycles in NZ and Australia:** FBU is levered to cyclical construction activity in NZ and AU, weighted to residential in both markets.
- **Competitive pressures:** Competition and cost inflation could materially influence FBU's market share and margins.
- **Construction losses:** Consensus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

Figure 4. EPS and FCFPS



Source: 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%

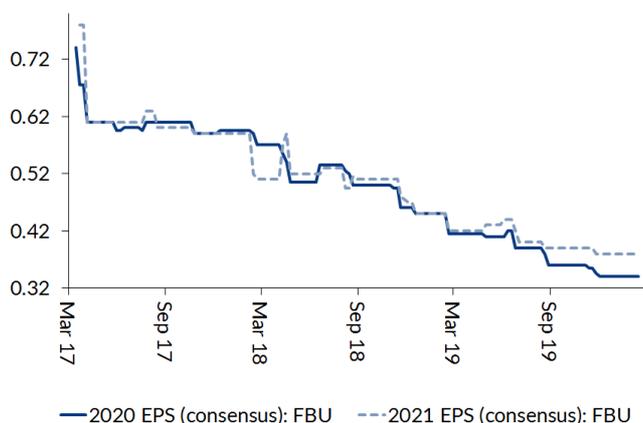
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

**Figure 7. International valuation comparisons**

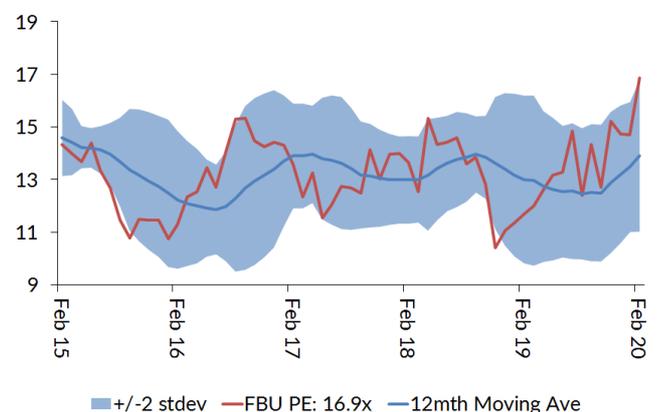
Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld 2021E
				2020E	2021E	2020E	2021E	2020E	2021E	
(metrics re-weighted to reflect FBU's balance date - June)										
<b>Fletcher Building</b>	<b>FBU NZ</b>	<b>NZ\$5.41</b>	<b>NZ\$4,313</b>	<b>16.7x</b>	<b>17.0x</b>	<b>5.2x</b>	<b>5.0x</b>	<b>8.9x</b>	<b>9.1x</b>	<b>4.3%</b>
Metro Performance Glass *	MPG NZ	NZ\$0.27	NZ\$50	4.2x	3.7x	2.9x	3.1x	5.3x	5.3x	15.1%
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\$3.18	A\$2,072	17.1x	16.7x	9.8x	9.6x	14.7x	14.3x	4.1%
Boral	BLD AT	A\$4.80	A\$5,627	16.4x	14.7x	8.0x	7.4x	15.2x	13.6x	4.4%
CSR	CSR AT	A\$4.80	A\$2,359	18.9x	17.5x	8.6x	8.5x	12.7x	12.6x	4.4%
Wagners Holding Co	WGN AT	A\$1.85	A\$346	27.2x	14.9x	11.9x	8.5x	18.8x	11.9x	2.9%
GWA Group	GWA AT	A\$3.95	A\$1,043	19.9x	19.0x	14.1x	12.6x	15.4x	14.8x	4.5%
James Hardie Industries PLC	JHX AT	US\$20.66	US\$9,150	24.5x	21.7x	16.4x	14.7x	20.4x	18.1x	2.6%
Reece	REH AT	A\$11.58	A\$6,494	26.7x	24.1x	14.7x	13.7x	19.3x	17.7x	1.9%
CRH PLC	CRH ID	€35.08	€27,607	15.6x	14.3x	9.0x	8.7x	14.1x	13.3x	2.3%
LafargeHolcim	LHN SW	CHF49.03	CHF30,199	13.5x	12.4x	6.5x	6.4x	10.4x	9.8x	4.4%
<b>Compcpo Average:</b>				<b>19.0x</b>	<b>15.5x</b>	<b>9.6x</b>	<b>8.8x</b>	<b>14.2x</b>	<b>12.5x</b>	<b>4.8%</b>
<b>FBU Relative:</b>				<b>-12%</b>	<b>10%</b>	<b>-46%</b>	<b>-43%</b>	<b>-37%</b>	<b>-28%</b>	<b>-11%</b>

EV = Current Market Cap + Actual Net Debt

Source: \*Forsyth Barr analysis, Bloomberg Consensus, Compcpo 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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