

Fletcher Building

Preparing for the Unknown

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NEUTRAL

Fletcher Building (FBU) has outlined its response to an expected sharp downturn in construction activity. Unfortunately, FBU did not enter the crisis in fighting shape. NZ margins have long been under pressure. Australian turnaround efforts have delivered little tangible reward. Necessary reinvestment has elevated capex. The risk is this downturn is not only cyclical, but leads to a further erosion in the business's underlying quality. Whilst FBU's share price remains down sharply from pre COVID-19 levels, it's not at a level where we see clear value. Maintain NEUTRAL.

NZX Code	FBU	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$3.30	NPAT* (NZ\$m)	367.0	104.8	170.2	157.8	EV/EBITDA	4.1	4.7	4.1	4.2
Target price	NZ\$3.80	EPS* (NZc)	43.1	12.6	20.7	19.2	EV/EBIT	5.4	10.5	8.2	8.8
Risk rating	Medium	EPS growth* (%)	n/a	-70.7	63.9	-7.3	PE	7.6	26.1	15.9	17.2
Issued shares	821.7m	DPS (NZc)	23.0	0.0	15.0	14.0	Price / NTA	0.9	1.1	1.0	1.0
Market cap	NZ\$2,712m	Imputation (%)	0	n/a	67	64	Cash div yld (%)	7.0	0.0	4.5	4.2
Avg daily turnover	1,511k (NZ\$7,042k)	*Based on normalised profits					Gross div yld (%)	7.0	n/a	5.7	5.3

Locked out in Level 4; a grind through Levels 3 and 2

Unsurprisingly, FBU has been materially impacted by COVID-19 restrictions. Through Level 4 lockdown NZ revenues were minimal. Since construction has recommenced, activity has recovered to c.80% of FBU's pre COVID-19 forecasts. In Australia, where construction is deemed an essential service and was not closed, constraints have reduced revenue to c.90% of FBU's pre COVID-19 expectations.

In April, FBU recorded aNZ EBIT loss of NZ\$55m (net of NZ\$22m of wage subsidies and, we estimate, c.NZ\$12m of wage reductions), and was breakeven in Australia. Despite the bounce back in activity, earnings remain materially impacted. FBU stated it expects to be broadly breakeven in the 4Q net of the April loss, wage reductions, and a total NZ\$66m (12 weeks) of wage subsidies. We estimate FBU's update implies FY20 EBIT of c.NZ\$275–300m (cf. 1H20 NZ\$219m/prior guidance NZ\$515–565m/FY19 NZ\$631m).

Planning for a sharp downturn ahead

FBU expects COVID-19 "to have a significant impact" on construction activity in NZ/AU. It has acknowledged the extreme level of uncertainty at this time, but has outlined a (in our view, not unreasonable) base case in which construction falls by c.10–30% across the various NZ/AU segments. FBU does expect government infrastructure investment to provide some medium-term offset, but there will be a lag before projects commence. FBU is responding to the expected downturn with a number of cost reduction initiatives, including a 10% reduction in its workforce. We estimate the plans outlined amount to targeted savings of c.NZ\$235m pa (or c.NZ \$170m in FY21 net of wage subsidies received in FY20).

Risk COVID-19 causes further underlying deterioration in FBU's businesses

Our forecasts are revised by EPS FY20/21E -11%/+10% (really just tweaks when near-term forecasts include a lot of guesswork). Construction is a later-cycle industry. We anticipate activity and FBU's revenue will bounce once lockdown restrictions are fully lifted, but fade as current projects are completed and the pipeline empties. There is risk both around the magnitude of the downturn, and, more significantly, of further underlying deterioration in FBU's businesses. Competition may continue (or compound) margin pressures. Falling demand exacerbates the challenges of executing on turnaround initiatives. And a pullback in capex may starve the business of necessary investment. Our concern is FBU may emerge from the downturn weaker than when it went in.

Fletcher Building (FBU)

Priced as at 20 May 2020 (NZ\$) **3.30**

12-month target price (NZ\$)*	3.80
Expected share price return	15.2%
Net dividend yield	4.2%
Estimated 12-month return	19.3%

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

Spot valuations (NZ\$)	
1. DCF	3.54

DCF valuation summary (NZ\$m)	
Total firm value	5,903
(Net debt)/cash	(325)
Less: Capitalised operating leases	(2,668)
Value of equity	2,910

Profit and Loss Account (NZ\$m)	2018A	2019A	2020E	2021E	2022E
Sales revenue	9,471.0	9,307.0	7,041.5	7,123.9	7,164.1
Normalised EBITDA	264.0	830.0	662.7	793.0	782.8
Depreciation and amortisation	(214.0)	(199.0)	(369.2)	(396.8)	(410.4)
Normalised EBIT	50.0	631.0	293.5	396.3	372.5
Net interest	(157.0)	(118.0)	(144.3)	(141.8)	(141.1)
Associate income	0	0	0	0	0
Tax	58.0	(133.0)	(33.9)	(71.3)	(64.8)
Minority interests	11.0	13.0	10.4	13.0	8.7
Normalised NPAT	(60.0)	367.0	104.8	170.2	157.8
Abnormals/other	(130.0)	(203.0)	(35.0)	0	0
Reported NPAT	(190.0)	164.0	69.8	170.2	157.8
Normalised EPS (cps)	(8.3)	43.1	12.6	20.7	19.2
DPS (cps)	0	23.0	0	15.0	14.0

Growth Rates	2018A	2019A	2020E	2021E	2022E
Revenue (%)	0.8	-1.7	-24.3	1.2	0.6
EBITDA (%)	-63.7	>100	-20.2	19.7	-1.3
EBIT (%)	-90.5	>100	-53.5	35.0	-6.0
Normalised NPAT (%)	n/a	n/a	-71.4	62.3	-7.3
Normalised EPS (%)	n/a	n/a	-70.7	63.9	-7.3
Ordinary DPS (%)	-100.0	n/a	-100.0	n/a	-6.7

Cash Flow (NZ\$m)	2018A	2019A	2020E	2021E	2022E
EBITDA	264.0	830.0	662.7	793.0	782.8
Working capital change	430.0	(404.0)	(30.1)	(73.1)	(16.4)
Interest & tax paid	(243.0)	(156.0)	(185.4)	(256.7)	(263.3)
Other	(55.0)	(117.0)	(15.0)	0	0
Operating cash flow	396.0	153.0	432.2	463.2	503.2
Capital expenditure	(304.0)	(348.0)	(387.0)	(200.0)	(300.0)
(Acquisitions)/divestments	76.0	1,262.0	0	0	0
Other	0	0	(164.7)	(166.7)	(168.6)
Funding available/(required)	168.0	1,067.0	(119.5)	96.5	34.6
Dividends paid	(123.0)	(68.0)	(127.6)	(41.1)	(123.3)
Equity raised/(returned)	893.0	(81.0)	(147.0)	0	0
(Increase)/decrease in net debt	938.0	918.0	(394.1)	55.4	(88.7)

Balance Sheet (NZ\$m)	2018A	2019A	2020E	2021E	2022E
Working capital	1,641.0	1,384.0	1,226.1	1,203.2	1,194.7
Fixed assets	2,231.0	1,754.0	1,927.0	1,915.6	1,991.0
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	764.4	737.5	723.5
Total funds employed	6,333.0	5,084.0	6,548.8	6,490.0	6,545.3
Net debt/(cash)	1,273.0	325.0	673.5	553.4	579.9
Lease liability	0	0	1,822.8	1,843.8	1,863.3
Other liabilities	918.0	586.0	398.0	302.0	277.1
Shareholder's funds	4,118.0	4,141.0	3,622.5	3,758.8	3,792.9
Minority interests	24.0	32.0	32.0	32.0	32.0
Total funding sources	6,333.0	5,084.0	6,548.8	6,490.0	6,545.3

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

Valuation Ratios	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	15.8	4.1	4.7	4.1	4.2
EV/EBIT (x)	83.3	5.4	10.5	8.2	8.8
PE (x)	n/a	7.6	26.1	15.9	17.2
Price/NTA (x)	1.2	0.9	1.1	1.0	1.0
Free cash flow yield (%)	3.4	-7.2	1.7	9.7	7.5
Net dividend yield (%)	0.0	7.0	0.0	4.5	4.2
Gross dividend yield (%)	0.0	7.0	n/a	5.7	5.3

Capital Structure	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	0.3	5.3	2.0	2.8	2.6
Interest cover EBITDA (x)	1.7	7.0	4.6	5.6	5.5
Net debt/ND+E (%)	23.6	7.3	15.7	12.8	13.3
Net debt/EBITDA (x)	4.8	0.4	1.0	0.7	0.7

Key Ratios	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	0.6	8.2	3.4	4.5	4.3
Return on equity (%)	-1.5	8.9	2.9	4.5	4.2
Return on funds employed (%)	-1.1	8.8	4.4	5.7	5.2
EBITDA margin (%)	2.8	8.9	9.4	11.1	10.9
EBIT margin (%)	0.5	6.8	4.2	5.6	5.2
Capex to sales (%)	3.2	3.7	5.5	2.8	4.2
Capex to depreciation (%)	142	175	105	50	73
Imputation (%)	100	0	n/a	67	64
Pay-out ratio (%)	0	53	0	72	73

Operating Performance	2018A	2019A	2020E	2021E	2022E
External revenue (NZ\$m)					
New Zealand	5,063	5,220	4,234	4,448	4,423
Australia	3,018	2,944	2,653	2,520	2,582
Rest of World	1,390	1,143	154	156	159
Total external revenue	9,471	9,307	7,041	7,124	7,164

EBIT (NZ\$m)					
Concrete	90	84	41	81	61
Building Products	132	127	77	109	87
Distribution	104	104	64	80	54
Steel	49	33	3	9	9
Construction	(608)	47	25	26	49
Residential / Land Developm't	136	137	81	88	91
Australia	114	57	38	39	58
Divested	78	82	0	0	0
Corporate / other	(45)	(40)	(35)	(36)	(36)
Total EBIT	50	631	294	396	372

EBIT (NZ\$m)					
New Zealand	(180)	467	246	347	300
Australia	123	54	30	32	51
Rest of World	107	110	17	17	22
Total EBIT	50	631	294	396	372

Investment Summary

Unfortunately, Fletcher Building (FBU) did not enter the COVID-19 crisis in fighting shape. NZ margins have long been under pressure. Australian turnaround efforts have delivered little tangible reward. Necessary reinvestment has elevated capex. The risk is this downturn is not only cyclical, but leads to a further erosion in the business's underlying quality. Whilst FBU's share price remains down sharply from pre COVID-19 levels, it's not at a level where we see clear value. NEUTRAL.

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.1–2% EBIT return on the c.NZ\$3b acquisition cost. FBU is aiming to 4x its Australian EBIT (vs. FY19) over the next five years through improved margins and new investment. We are sceptical given competitive constraints and high operating leverage to slowing demand.

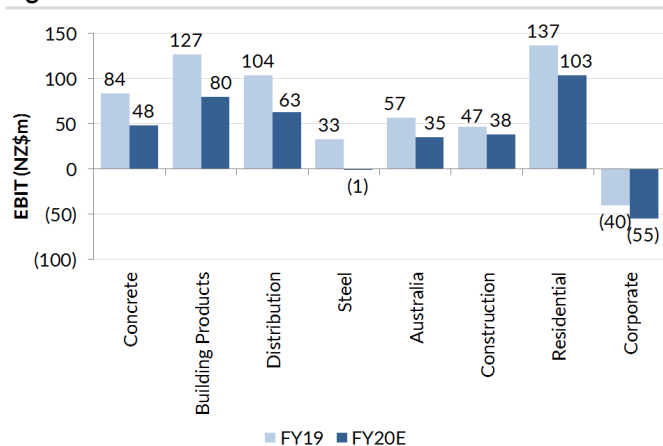
Earnings and cashflow outlook

- **Limited medium-term free cash flow:** 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.1.0x even on our COVID-19 impacted earnings forecasts, below its 1.5–2.5x EBITDA target.

Risk factors

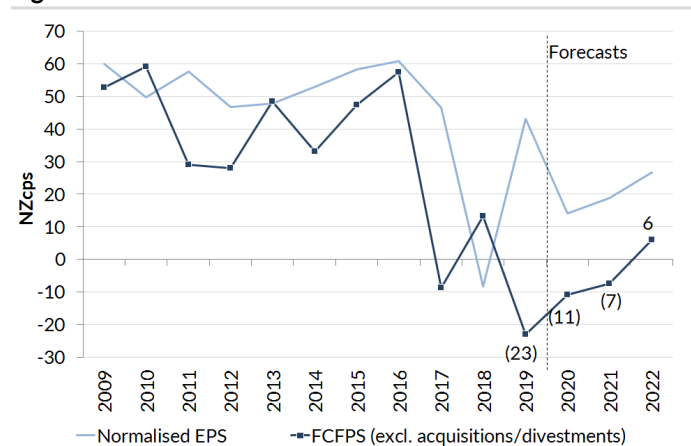
- **COVID-19:** Represents a massive near-term uncertainty for most businesses. We anticipate construction activity will bounce once lockdown restrictions are fully lifted, but fade as current projects are completed and the pipeline empties.
- **Construction cycles in NZ and Australia:** FBU is levered 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 1. Divisional EBIT

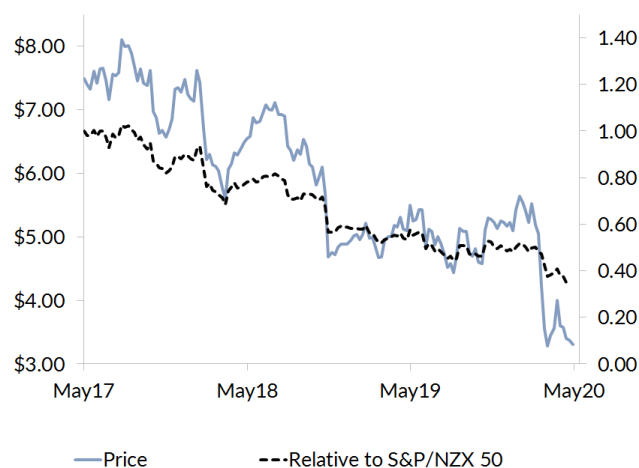


Source: Company reports, Forsyth Barr analysis

Figure 2. EPS and FCFPS



Source: Company reports, Forsyth Barr analysis

Figure 3. Price performance


Source: Forsyth Barr analysis

Figure 4. Substantial shareholders

Shareholder	Latest Holding
Perpetual	8.9%
Schroder Investment Management Group	8.3%
Commonwealth Bank of Australia	6.0%
The Vanguard Group	5.6%

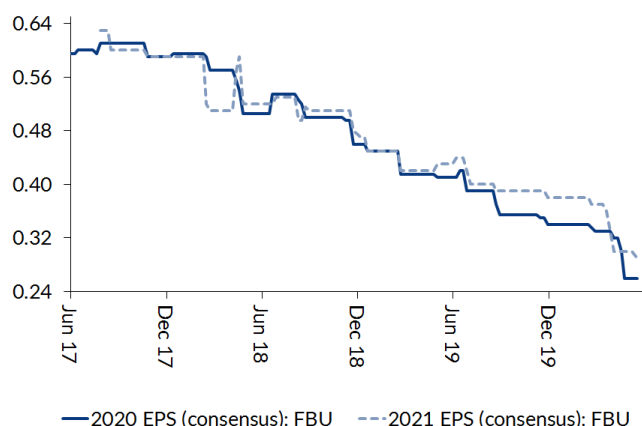
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 5. International valuation comparisons

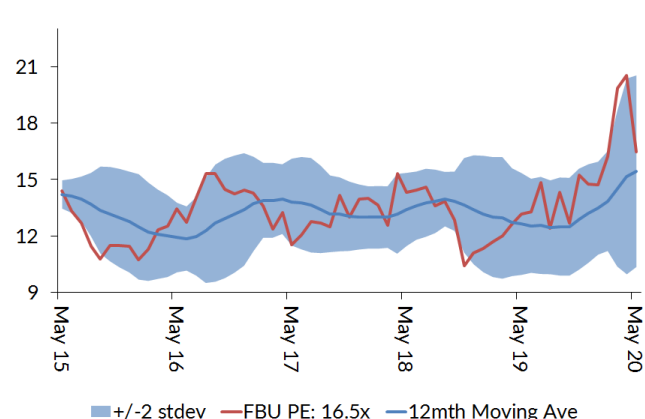
Company	Code	Price	Mkt Cap (m)	PE 2020E	PE 2021E	EV/EBITDA 2020E	EV/EBITDA 2021E	EV/EBIT 2020E	EV/EBIT 2021E	Cash Yld 2021E
(metrics re-weighted to reflect FBU's balance date - June)										
Fletcher Building	FBU NZ	NZ\$3.30	NZ\$2,712	26.1x	15.9x	4.6x	3.8x	10.3x	7.7x	4.5%
Metro Performance Glass *	MPG NZ	NZ\$0.16	NZ\$29	2.4x	2.1x	2.5x	2.6x	4.5x	4.5x	26.1%
Steel & Tube Holdings *	STU NZ	NZ\$0.63	NZ\$105	24.1x	9.1x	3.5x	2.9x	8.5x	5.6x	9.5%
ADELAIDE BRIGHTON	ABC AT	A\$2.43	A\$1,582	24.7x	15.3x	8.9x	8.4x	27.8x	13.5x	4.1%
BORAL	BLD AT	A\$2.45	A\$3,003	13.7x	15.6x	6.8x	6.9x	15.8x	17.8x	4.0%
CSR	CSR AT	A\$3.51	A\$1,704	13.9x	14.4x	5.7x	6.3x	9.4x	10.0x	4.2%
WAGNERS HOLDING CO	WGN AT	A\$0.86	A\$161	47.6x	14.8x	12.4x	8.1x	32.5x	14.4x	2.4%
GWA GROUP	GWA AT	A\$2.69	A\$710	14.2x	14.2x	10.1x	10.2x	11.8x	12.1x	5.7%
JAMES HARDIE INDUSTRIES-CDI	JHX AT	US\$13.93	US\$6,173	18.7x	21.3x	12.7x	13.6x	16.5x	19.0x	1.9%
REECE	REH AT	A\$8.17	A\$5,278	20.7x	21.1x	13.3x	13.1x	21.0x	19.8x	1.4%
CRH PLC	CRH ID	€25.32	€19,872	14.0x	15.4x	7.3x	7.5x	12.8x	13.3x	3.3%
LAFARGEHOLCIM-REG	LHN SW	CHF35.46	CHF21,841	11.7x	12.3x	5.7x	5.6x	9.8x	9.2x	5.6%
Compc Average:				18.7x	14.1x	8.1x	7.8x	15.5x	12.7x	6.2%
FBU Relative:				40%	13%	-43%	-51%	-33%	-39%	-27%

EV = Current Market Cap + Actual Net Debt

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

Figure 6. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 7. One year forward PE (x)


Source: Forsyth Barr analysis

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