

22 October 2019

James Hardie Industries

Earnings revisions

James Hardie Industries' (JHX) share price has been the best performer among our coverage in 2019 to date, rising 64% versus the S&P/ASX 200 increasing 18%. Based on our revised estimates, however, we see further potential upside.

We came away from James Hardie's investor trip last month with the impression that the North America division would report another strong quarter on 7 November (2Q20). Key data points have also moved favourably for the company (for example, US housing starts, pulp and freight), leading us to believe the bottom end of FY20 net profit guidance might be lifted.

Our FY21 EPS forecast is now 5% above Bloomberg consensus and suggests the stock is trading on a price-to-earnings (P/E) multiple of 20x blended FY20-21E (excluding asbestos).

We maintain our Accumulate recommendation on James Hardie and raise our target price to \$27.00 from \$23.50.

- **Expecting PDG of 4% in 2Q20** – Based on data from the US Census Bureau and our estimates, the exteriors markets index for the North America fibre cement (NAFC) division looks to have been slightly negative (at -0.5%) for the September quarter. We project exteriors growth of 3.5%, implying primary demand growth (PDG) of 4%.
- **Input costs** – Pulp and freight combined look to have been slightly positive for NAFC margins in 2Q20, following a slight headwind in 1Q20. This dynamic underpins our estimate for a 26% divisional earnings before interest and tax (EBIT) margin in 2Q20.
- **Australia and Germany markets** – Given declining housing approval volumes in Australia, we expecting volumes for the Asia Pacific (APAC) division to fall 9% in the quarter. We also note the Construction PMI for Germany was soft in the September quarter. We expect fibre gypsum volumes in Europe to slip 1% on the same period last year, offset by continued strong growth in fibre cement sales in Europe.
- **Net profit guidance** – James Hardie set a net profit range for FY20 of US\$325–365m at the 1Q20 result. Given positive commentary from management on the recent investor trip and movements in key variables, including US housing activity and inputs, we believe it is possible the bottom-end of this range could be lifted. Our estimate is US\$354m.
- **Earnings revisions** – We have made the following changes to our estimates: NAFC PDG of 5% in FY21–22 (previously 4%); NAFC EBIT margin of 26% in FY21 (previously 25%). Our target price has increased to \$27.00 from \$23.50 due to the above changes, as well as our expectation of higher long-term earnings in Europe and our more accurate modelling of capital expenditure requirements.

Recommendation

Accumulate

Risk

Higher

Target price

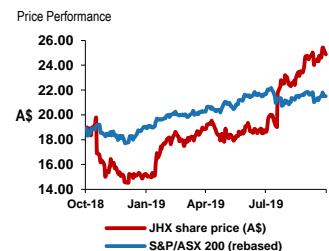
▲ \$27.00

Previous

\$23.50

Last price

\$24.89



Price Performance



Company Data

Shares O/S (mn)	443
52-week range (\$)	25.56-14.38
Market cap (\$ mn)	7,555.40
Exchange rate	1.46
Free float(%)	-
3M - Avg daily vol (mn)	1.85
3M - Avg daily val (\$ mn)	28.3
Volatility (90 Day)	29
Index	ASX 100
BBG BUY HOLD SELL	8 0 3

Key Metrics (FYE Mar)

US\$ in millions	FY19A	FY20E	FY21E	FY22E
Financial Estimates				
Revenue	2,507	2,563	2,773	3,021
Adj. EBITDA	524	621	688	728
Adj. EBIT	405	489	551	591
Adj. net income	301	354	407	438
Adj. EPS	0.68	0.80	0.92	0.99
BBG EPS	0.68	0.80	0.89	-
Cashflow from operations	288	384	396	422
FCFF	31	215	312	331
Margins and Growth				
Revenue growth	22.0%	2.3%	8.2%	8.9%
EBITDA margin	20.9%	24.2%	24.8%	24.1%
EBITDA growth	7.0%	18.5%	10.8%	5.8%
EBIT margin	16.1%	19.1%	19.9%	19.6%
Net margin	12.0%	13.8%	14.7%	14.5%
Adj. EPS growth	3.0%	17.6%	15.2%	7.6%
Ratios				
Adj. tax rate	14.8%	18.3%	18.1%	18.3%
Interest cover	10.1	11.0	12.9	13.3
Net debt/Equity	1.3	1.1	0.9	0.8
Net debt/EBITDA	2.5	2.1	1.8	1.7
ROCE	22.9%	16.3%	17.1%	17.1%
ROE	79.8%	33.3%	32.7%	30.6%
Valuation				
FCFF yield	0.4%	2.8%	4.1%	4.4%
Dividend yield	2.1%	2.3%	2.9%	3.5%
EV/EBITDA	17.4	14.7	13.2	12.4
Adj. P/E	25.2	21.4	18.6	17.3

Summary Investment Thesis and Valuation

James Hardie has been a strong performer year-to-date but we remain positive given favourable trends in key data points (e.g. US housing starts; pulp; freight) and internal initiatives (i.e. PDG has gained clear traction). Our FY21 EPS is 5% above Bloomberg consensus and suggests the stock is trading on a PE of 20x blended FY20-21 (ex. asbestos).

Our price target is based on a combination of our Mar-20 sum-of-the-parts (SoP) DCF and relative multiple valuations.

Performance Drivers

Market	9%
Sector	0%
Macro	17%
Style	12%
Idiosyn.	62%

Factors	6M Corr	1Y Corr
Market: MSCI Australia	-0.11	0.31
Sect: Materials	-0.12	-0.01
Ind: Materials	-0.18	-0.05
Macro:		
Crude Oil	0.13	0.26
TR/CC CRB ER Index	0.04	0.21
Non-Energy Commod	0.15	0.18
Quant Styles:		
Size	-0.27	-0.25
LowVol	-0.08	-0.24
Growth	-0.12	-0.08

Sources for: Performance Drivers – Bloomberg, Ord Minnett Quantitative and Derivatives Strategy; all other tables are company data and Ord Minnett estimates.

Earnings forecasts

See Table 2 for an overview of our 2QFY20 estimates.

Table 1: JHX – 2QFY20 earnings preview

GROUP RESULTS	Unit	2Q18A	2Q19A	vs. pcg	2Q20E	vs. pcg
Volume						
NA Fibre Cement	mmsf	561.6	591.7	5.4%	607.8	2.7%
APAC Fibre Cement	mmsf	130.0	142.1	9.3%	129.9	-8.6%
Europe Fibre Cement	mmsf	9.4	194.3	nm	194.3	-0.0%
Group Volumes	mmsf	701.0	928.1		931.9	0.4%
Revenue						
NA Fibre Cement	US\$m	398.1	435.6	9.4%	459.4	5.5%
APAC Fibre Cement	US\$m	113.4	117.3	3.4%	102.5	-12.6%
Europe	US\$m	10.5	87.4	732.4%	86.3	-1.3%
Other Businesses	US\$m	3.8	4.3	13.2%	-	-100.0%
Group Revenue	US\$m	525.8	644.6	22.6%	648.2	0.6%
Group EBITDA	US\$m	129.2	137.7	6.6%	157.2	14.1%
Group D&A	US\$m	-23.4	-30.8	31.6%	-32.5	5.5%
EBIT						
NA Fibre Cement	US\$m	97.4	99.5	2.2%	118.5	19.1%
APAC Fibre Cement	US\$m	30.5	27.5	-9.8%	22.6	-18.0%
Europe	US\$m	0.3	3.4	-	8.0	134.4%
Other Businesses	US\$m	-2.1	-1.8	-14.3%	-	-100.0%
Research & Development	US\$m	-7.2	-7.1	-1.4%	-7.4	-
Corporate	US\$m	-13.1	-14.6	11.5%	-17.0	-
Group EBIT (ex. Asbestos)	US\$m	105.8	106.9	1.0%	124.7	16.6%
<i>EBIT Margin</i>	%	20.1%	16.6%		19.2%	
Net Interest (Expense) Revenue	US\$m	-7.4	-12.9	74.3%	-14.1	9.2%
Tax	US\$m	-22.8	-13.1	-42.5%	-20.2	54.1%
NPAT pre-abnormals (ex. Asbestos)	US\$m	75.6	80.9	32.8%	90.4	11.7%
EPS pre-abnormals (ex. Asbestos)	US¢ps	17.1	18.3	6.8%	20.4	11.7%
DPS	US¢ps	10.0	10.0	-	11.0	10.0%
<i>Implied Tax Rate</i>	%	23.2%	13.9%		18.3%	
<i>Payout Ratio</i>	%	58.5%	54.8%		53.9%	

Source: Company Reports, Ord Minnett estimates

We have updated our estimates ahead of James Hardie's 2Q20 result. Our changes are primarily driven by the following:

- We have increased our primary demand growth (PDG) assumptions in North America to 4.5% in FY20, 5% in FY21 and FY22, and 4% in FY23 (previously 4% over FY20-22 and 3% in FY23). We continue to assume 3% over FY24-30.
- Our EBIT margin for North America has increased from 25% to 26% in FY21. Our terminal margin has moved from 24% to 25%. This in part reflects some benefits from lean initiatives dropping to the bottom line.
- We have increased our sales and margin estimates for the Europe division. Our divisional EBIT in FY30 is €108m, just over half of management's €200m target.

Table 2: Earnings revisions

Financial Year	Unit	FY20	FY21	FY22	3yr AVG
Revenue					
New	\$m	2,563	2,773	3,021	
Old	\$m	2,559	2,747	2,966	
Difference %	%	0.2%	0.9%	1.9%	1.0%
EBIT					
New	\$m	489	551	591	
Old	\$m	487	527	577	
Difference %	%	0.5%	4.6%	2.5%	2.5%
NPAT (pre-significant items)					
New	\$m	354	407	438	
Old	\$m	352	386	425	
Difference %	%	0.5%	5.4%	3.2%	3.0%
EPS (pre-significant items)					
New	\$m	80.0	92.1	99.1	
Old	\$m	79.6	87.4	96.1	
Difference %	%	0.5%	5.4%	3.2%	3.0%
DPS					
New	\$m	40.0	49.0	59.0	
Old	\$m	42.0	46.0	58.0	
Difference %	%	-4.8%	6.5%	1.7%	1.2%

Source: Ord Minnett estimates

Investment Thesis, Valuation and Risks

James Hardie Industries *(Accumulate; Price Target: \$27.00)*

Investment Thesis

James Hardie has been a strong performer year-to-date, but we remain positive given favourable trends in key data points (e.g. US housing starts; pulp; freight) and internal initiatives (i.e. PDG has gained clear traction). Our FY21 EPS is 5% above Bloomberg consensus and suggests the stock is trading on a PE of 20x blended FY20-21.

Valuation

Our \$27.00 Dec-20 price target is based on a combination of our Mar-20 sum-of-the-parts (SoP) DCF and relative multiple valuations. We calculate our SoP valuation based on the individual cash flow streams of each discrete business segment. Our multiple valuation is based on James Hardie's historical P/E ratio relative to the broader market. Our group post-tax WACC is 8.7%. The key figures that make up this discount rate are a cost of equity of 8.8% and a post-tax cost of debt of 4.2%. We apply a Beta of 1.05 within this.

JHX – DCF-based SoP valuation

Segment	Valuation methodology / Comment	US\$m	\$/share
North America Fibre Cement	DCF-based valuation (ex. Changes in working capital and provisions)	9,323	31.01
APAC Fibre Cement	DCF-based valuation (ex. Changes in working capital and provisions)	1,386	4.61
Europe	DCF-based valuation (ex. Changes in working capital and provisions)	1,024	3.41
Less: Corporate and R&D	DCF-based valuation (incl. Capex, group changes in working capital and provisions)	-2,033	-6.76
Enterprise Value		9,700	32.26
Less: Net Debt	Group net debt as at year-end: FY20	-1,310	-4.36
Less: Asbestos	Based on JHX financial statements at FY20	-440	-1.46
Less: Provisions	Based on JHX financial statements at FY20	-108	-0.36
Estimated equity value	Group SoP valuation	7,843	26.08

Source: J.P. Ord Minnett estimates

Risks to Rating and Price Target

Downside risks to our Accumulate rating and price target include a strengthening AUD/USD exchange-rate, weaker-than-expected housing construction growth in the US (including the repair & remodel segment), strengthening pulp price and/or transportation costs, PDG falling short of our targeted levels.

Further potential catalysts include higher growth rates in the US or Australian housing markets, a material decline in the pulp price and/or transportation costs, faster-than-expected penetration of the US siding market, and depreciation of the AUD.

James Hardie Industries: Summary of Financials

Income Statement						Cash Flow Statement					
	FY18A	FY19A	FY20E	FY21E	FY22E		FY18A	FY19A	FY20E	FY21E	FY22E
Revenue	2,055	2,507	2,563	2,773	3,021	Cash flow from operating activities	302	288	384	396	422
Adj. EBITDA	490	524	621	688	728	o/w Depreciation & amortization	92	119	132	137	137
D&A	(92)	(119)	(132)	(137)	(137)	o/w Changes in working capital	(36)	(51)	(16)	(29)	(30)
Adj. EBIT	398	405	489	551	591	Cash flow from investing activities	(201)	(854)	(215)	(127)	(136)
Net Interest	(31)	(52)	(56)	(54)	(55)	o/w Capital expenditure	(204)	(301)	(215)	(127)	(136)
Adj. PBT	367	353	433	497	536	as % of sales	9.9%	12.0%	8.4%	4.6%	4.5%
Tax	(28)	(72)	(79)	(90)	(98)	Cash flow from financing activities	108	371	(177)	(217)	(261)
Minority Interest	0	0	0	0	0	o/w Dividends paid	(178)	(172)	(177)	(217)	(261)
Adj. Net Income	291	301	354	407	438	o/w Shares issued/(repurchased)	(16)	(6)	0	0	0
Reported EPS	0.33	0.52	0.80	0.92	0.99	o/w Net debt issued/(repaid)	325	542	0	0	0
Adj. EPS	0.66	0.68	0.80	0.92	0.99	Net change in cash	210	(196)	(8)	52	25
DPS	0.40	0.36	0.40	0.49	0.59	Adj. Free cash flow to firm	131	31	215	312	331
Payout ratio	121.1%	69.7%	50.1%	53.3%	59.7%	y/y Growth	(37.2%)	(76.5%)	595.8%	45.2%	6.0%
Shares outstanding	442	443	443	443	443	Ratio Analysis	FY18A	FY19A	FY20E	FY21E	FY22E
Segmental Earnings						Gross margin	35.5%	33.2%	41.4%	41.4%	39.9%
North America Fibre Cement Revenue	1,578	1,677	1,794	1,969	2,156	EBITDA margin	23.8%	20.9%	24.2%	24.8%	24.1%
EBIT	382	388	458	512	539	EBIT margin	19.3%	16.1%	19.1%	19.9%	19.6%
APAC Revenue	425	447	400	408	436	Net profit margin	14.2%	12.0%	13.8%	14.7%	14.5%
EBIT	108	100	93	94	104	ROE	(134.3%)	79.8%	33.3%	32.7%	30.6%
Europe Revenue	36	368	368	397	428	ROA	13.4%	9.4%	8.7%	9.8%	10.4%
EBIT	0	10	33	43	51	ROCE	59.1%	22.9%	16.3%	17.1%	17.1%
Other Businesses Revenue	15	15	1	0	0	ROIC	32.8%	20.2%	23.2%	25.9%	27.3%
EBIT	(9)	(7)	0	0	0	SG&A/Sales	-	-	-	-	-
General Corp ex. asbestos and ASIC Revenue	-	-	-	-	-	Net debt/Equity	NM	1.3	1.1	0.9	0.8
EBIT	(56)	(62)	(64)	(65)	(67)	Net debt/EBITDA	1.2	2.5	2.1	1.8	1.7
Balance Sheet						Sales/Assets (x)	0.9	0.8	0.6	0.7	0.7
Cash and cash equivalents	282	79	79	131	156	Assets/Equity (x)	NM	8.5	3.8	3.3	2.9
Accounts receivable	203	255	260	281	306	Interest cover (x)	15.6	10.1	11.0	12.9	13.3
Inventories	256	317	323	349	381	Operating leverage	182.3%	8.1%	923.7%	154.7%	81.7%
Other current assets	103	103	103	103	103	Tax rate	20.6%	14.8%	18.3%	18.1%	18.3%
Current assets	843	754	765	865	946	Revenue y/y Growth	6.9%	22.0%	2.3%	8.2%	8.9%
PP&E	992	1,388	1,471	1,461	1,460	EBITDA y/y Growth	12.2%	7.0%	18.5%	10.8%	5.8%
LT investments	-	-	-	-	-	EPS y/y Growth	18.2%	3.0%	17.6%	15.2%	7.6%
Other non current assets	516	1,890	1,875	1,860	1,845	Valuation	FY18A	FY19A	FY20E	FY21E	FY22E
Total assets	2,351	4,033	4,111	4,186	4,252	P/E (x)	25.9	25.2	21.4	18.6	17.3
Short term borrowings	0	0	0	0	0	P/BV (x)	NM	7.8	6.6	5.6	5.0
Payables	193	256	250	268	295	EV/EBITDA (x)	17.2	17.4	14.7	13.2	12.4
Other short term liabilities	201	228	228	228	228	Dividend Yield	2.3%	2.1%	2.3%	2.9%	3.5%
Current liabilities	395	483	478	496	523	FX	FY18A	FY19A	FY20E	FY21E	FY22E
Long-term debt	884	1,380	1,388	1,388	1,388	USDAUD	1.29	1.37	1.45	1.47	1.47
Other long term liabilities	1,294	1,195	1,094	960	822	USDEUR	0.86	0.86	0.89	0.88	0.87
Total liabilities	2,573	3,058	2,960	2,844	2,732	North America Key Metrics	FY18A	FY19A	FY20E	FY21E	FY22E
Shareholders' equity	(222)	974	1,151	1,342	1,519	Volume Growth	1.1%	3.1%	4.9%	7.6%	6.9%
Minority interests	0	0	0	0	0	PDG (Exteriors)	(3.0%)	0.6%	4.5%	5.0%	5.0%
Total liabilities & equity	2,351	4,033	4,111	4,186	4,252	Price increase	5.0%	2.9%	2.0%	2.0%	2.5%
BVPS	(0.50)	2.20	2.60	3.03	3.43	NA EBIT Margin	24.2%	23.1%	25.5%	26.0%	25.0%
y/y Growth	4.8%	(539.2%)	18.1%	16.6%	13.2%						
Net debt/(cash)	603	1,302	1,310	1,258	1,232						

Source: Company reports and Ord Minnett estimates.

Note: \$ in millions (except per-share data). Fiscal year ends Mar. o/w - out of which

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Guide to Ord Minnett Recommendations

Our recommendations are based on the total return of a stock – nominal dividend yield plus capital appreciation – and have a 12-month time horizon.

SPECULATIVE BUY	We expect the stock's total return (nominal yield plus capital appreciation) to exceed 20% over 12 months. The investment may have a strong capital appreciation but also has high degree of risk and there is a significant risk of capital loss.
BUY	The stock's total return (nominal dividend yield plus capital appreciation) is expected to exceed 15% over the next 12 months.
ACCUMULATE	We expect a total return of between 5% and 15%. Investors should consider adding to holdings or taking a position in the stock on share price weakness.
HOLD	We expect the stock to return between 0% and 5%, and believe the stock is fairly priced.
LIGHTEN	We expect the stock's return to be between 0% and negative 15%. Investors should consider decreasing their holdings.
SELL	We expect the total return to lose 15% or more.
RISK ASSESSMENT	Classified as Lower, Medium or Higher, the risk assessment denotes the relative assessment of an individual stock's risk based on an appraisal of its disclosed financial information, historical volatility of its share price, nature of its operations and other relevant quantitative and qualitative criteria. Risk is assessed by comparison with other Australian stocks, not across other asset classes such as Cash or Fixed Interest.

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