

Private Client Research

8 November 2019

James Hardie Industries

Second-quarter FY20 result review

James Hardie Industries (JHX) delivered a strong result, with adjusted net profit of US\$98.6 million for the second quarter FY20, 9% ahead of Ord Minnett's forecast due largely to margin performance, and US\$188.8 million for the first half. Management declared a first-half dividend of 10c per share versus our 11c per share estimate.

The North America fibre cement (NAFC) division achieved an earnings before interest and tax (EBIT) margin of 27.1% in the second quarter, versus our 25.8%. NAFC volumes grew by 4.9% (we expected +2.7%), with 6% growth in exteriors and flat volumes in interiors. Meanwhile, Asia Pacific (APAC) EBIT beat our estimate by 19.7%, while Europe EBIT was 27.2% below our forecast.

James Hardie delivered a strong second-quarter result as market share gains were ahead of expectations and margins rose year-on-year (YoY) across all divisions. The net profit guidance range for FY20 was increased by 3% at the mid-point.

Sentiment is understandably very positive towards the stock and expectations for earnings growth continue to rise. We are aware this lifts the hurdle for results to surprise on the upside and also raises the risk of a share price correction if business performance falters. Despite the strong share price reaction following the result, and this year (+8% and +76%, respectively), James Hardie does not screen as expensive, trading on a forward price-earnings (P/E) of 19x (excluding asbestos) is at a discount to historical levels and the All Industrials Index of P/E of 22x.

We also note that key external variables are moving favourably for James Hardie's North America division, including US housing starts, pulp and freight, raising the likelihood that the current upgrade cycle could persist.

We maintain our Accumulate recommendation on James Hardie and raise our target price to \$28.50 from \$27.00 due to changes to our earnings forecasts.

- **Primary demand growth** – Strong (6%) primary demand growth (PDG) was achieved in North America in the quarter and half. We believe this level of market share gains will persist through to FY22, before reverting to 3%. We note that over the past decade, PDG has varied significantly, ranging from -4% to +9% and averaging 4%.
- **Lean* program** – James Hardie is ahead of its 'lean' plan for FY20 – we estimate US\$5–10m of lean benefits were achieved in the half. Management flagged that this benefit dropped to the bottom line in the first half, but further savings will be reinvested from the second half. The investment will flow through to several line items in the division, such as cost of goods sold (COGS) and selling, general and administration (SG&A) costs, but also at the group level, to R&D and corporate.
- **APAC volume growth** – Volumes in APAC were roughly flat in 2Q20 (OMLe 8.6%), a solid result given moderating end markets. James Hardie estimates the addressable market in Australia contracted 8–10% in the first half. Performance in the quarter was driven by a combination of above-market volume growth in both Australia and the Philippines, and improved plant performance.
- **Earnings revisions** – We have increased our EPS forecasts by an average of 2% over the FY20–22 period, with higher PDG and margins in North America offset partially by higher R&D costs. These changes lead us to raise our December 2020 target price to \$28.50 from \$27.00.

Recommendation

Accumulate

Risk

Higher

Target price

▲ \$28.50

Previous

\$27.00

Last price

\$26.62



* Lean initiatives are aimed at the systematic elimination of waste within a business while optimising productivity levels. Lean principles are derived from the Japanese manufacturing industry – as waste is eliminated quality improves, while production time and cost are reduced.

Price Performance

Company Data

Shares O/S (mn)	442
52-week range (\$)	27.07-14.38
Market cap (\$ mn)	8,104.93
Exchange rate	1.45
Free float(%)	-
3M - Avg daily vol (mn)	1.82
3M - Avg daily val (\$ mn)	29.2
Volatility (90 Day)	32
Index	ASX 100
BBG BUY HOLD SELL	8 0 4

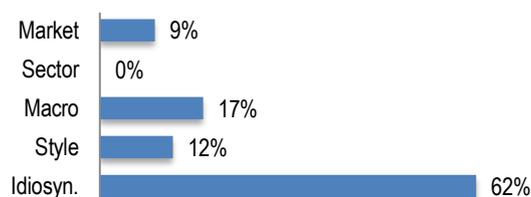
Key Metrics (FYE Mar)

US\$ in millions	FY19A	FY20E	FY21E	FY22E
Financial Estimates				
Revenue	2,507	2,597	2,830	3,082
Adj. EBITDA	524	631	717	737
Adj. EBIT	405	501	569	589
Adj. net income	301	365	422	435
Adj. EPS	0.68	0.82	0.95	0.98
BBG EPS	0.68	0.80	0.90	-
Cashflow from operations	288	389	415	426
FCFF	31	234	306	319
Margins and Growth				
Revenue growth	22.0%	3.6%	8.9%	8.9%
EBITDA margin	20.9%	24.3%	25.3%	23.9%
EBITDA growth	7.0%	20.5%	13.5%	2.8%
EBIT margin	16.1%	19.3%	20.1%	19.1%
Net margin	12.0%	14.1%	14.9%	14.1%
Adj. EPS growth	3.0%	21.4%	15.7%	3.2%
Ratios				
Adj. tax rate	14.8%	17.9%	18.2%	18.4%
Interest cover	10.1	11.3	13.5	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%	16.8%	17.6%	17.0%
ROE	79.8%	34.2%	33.6%	30.2%
Valuation				
FCFF yield	0.4%	2.9%	3.8%	3.9%
Dividend yield	2.0%	2.2%	2.8%	3.2%
EV/EBITDA	18.0	15.0	13.1	12.8
Adj. P/E	27.0	22.2	19.2	18.6

Summary Investment Thesis and Valuation

Sentiment is understandably very positive towards the stock and expectations for earnings growth continue to rise. We are aware that this lifts the hurdle for results to surprise on the upside and also raises the risk of a share price correction if business performance falters. However, James Hardie does not screen expensive – a P/E of 19x (ex. asbestos) is at a discount to its own history and the Industrials index of 22x. On our estimates, this multiple offers shareholders an FY20–22 EPS CAGR of 9%. We retain our Accumulate recommendation and continue to believe James Hardie is an attractive investment within the building materials sector.

Our \$28.50 Dec-20 price target is based on a blend of our Mar-20 sum-of-the-parts (SoP) DCF and relative multiple valuations.

Performance Drivers


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

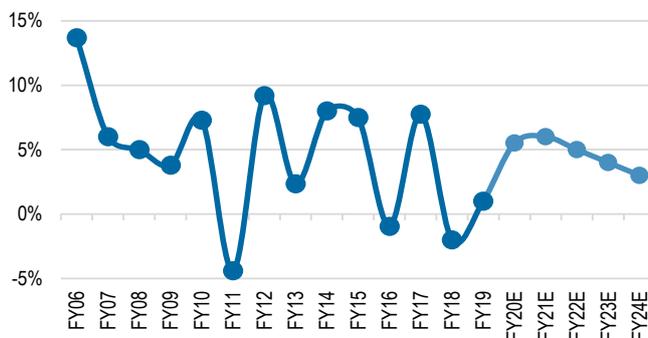
Sources for: Performance Drivers – Bloomberg, Ord Minnett Quantitative and Derivatives Strategy; all other tables are company data and Ord Minnett estimates.

Charting the Focal Points

FY20 expectations raised for NAFC PDG...

NAFC volumes grew 4.9% in 2Q20 (OMLe: +2.7%) including +6% in exteriors and flat in interiors. James Hardie noted that the underlying addressable market in North America was roughly flat in the quarter and half. This implies PDG of 6% for 2Q and 5.5% for 1H. Due to strong momentum in the business, James Hardie raised its FY20 PDG target range to 4-6% from 3-5%, while expecting the market to be up slightly (c.1%) for the full year. We factor in 5.5% PDG for FY20.

Figure 1: NAFC primary demand growth

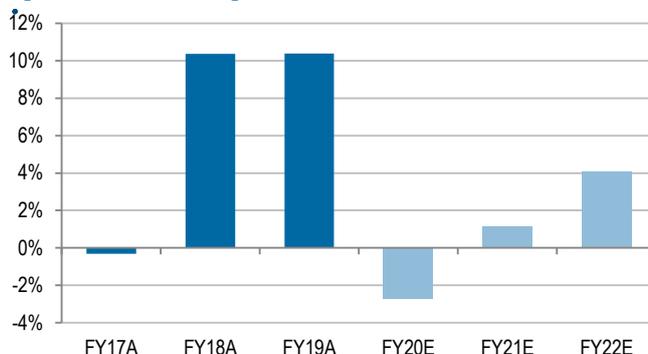


Source: Company reports, Ord Minnett estimates.

Impressive volume growth in APAC

Volumes in APAC grew 0.5% YoY in 2Q20 (OMLe: -8.6%), a solid result given moderating end markets; James Hardie estimates the addressable market in Australia contracted 8-10% in 1H. Performance in the quarter was driven by a combination of above-market volume growth in both Australia and the Philippines, and improved plant performance. For FY20, James Hardie continues to target 3-5% PDG in the region, and expects continued high-single-digit contraction in Australia. We forecast modestly lower volumes in FY20.

Figure 3: APAC volume growth YoY

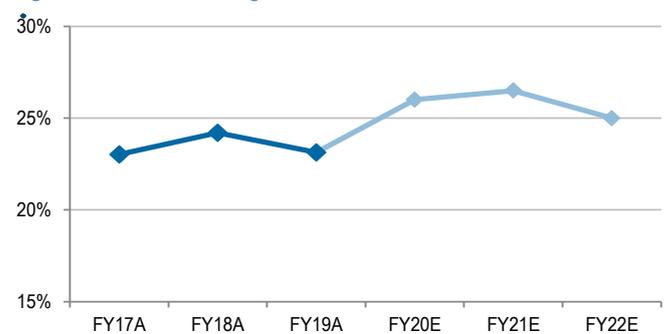


Source: Company reports, Ord Minnett estimates.

... and for NAFC margins

NAFC EBIT margin came in at 27.1% in 2Q20 (OMLe: 25.8%) and the target range for FY20 was lifted to 25–27%. The team noted it believes it is tracking ahead of its US\$20m Lean benefits target for FY20, with most of the savings dropped to the bottom line in 1H. If we assume US\$8m of benefits delivered in 1H, this represents a 1ppt EBIT margin uplift. Looking ahead, margins should be helped by a tailwind from pulp, partially offset by higher investments. We forecast 26% EBIT margin for FY20.

Figure 2: NAFC EBIT margin

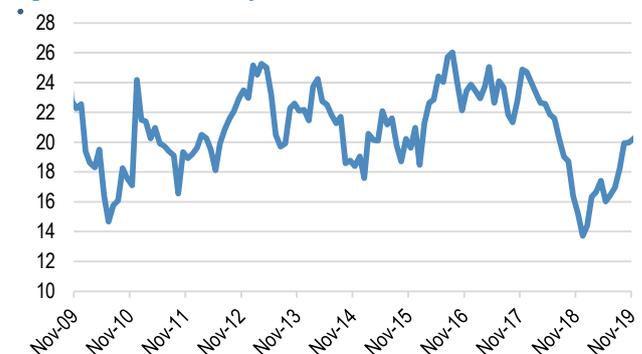


Source: Company reports, Ord Minnett estimates.

Trading on 21x; FY20–22 EPS CAGR 9%

James Hardie's share price rose 8% and it is now trading on 21x blended FY20–21 EPS, based on our estimates. We believe the rerate is not overdone given the solid outlook for the business ahead. We are forecasting FY20–22 EPS CAGR of 9.2%. We retain our Accumulate recommendation on the stock.

Figure 4: JHX P/E ratio 1-year forward



Source: Bloomberg.

2Q20 Result

2Q20 NPAT was 9% ahead of our estimate (largely due to margin performance). The North America Fiber Cement (NAFC) division achieved an EBIT margin of 27.1% (OMLe: 25.8%). NAFC volumes grew by 4.9% (OMLe: +2.7%), with +6% in exteriors and flat volumes in interiors. APAC EBIT beat our estimate by 19.7%, while Europe EBIT was 27.2% below our forecast.

Management declared a first half dividend of 10cps (OMLe: 11cps) – see Table 1 for a summary of financials.

Table 1: JHX – 2Q20 result

	UNIT	2Q19A	2Q20A	vs. pcp	2Q20E	vs. OMLe
Volume						
NA Fibre Cement	mmsf	591.7	620.9	4.9%	607.8	2.2%
APAC Fibre Cement	mmsf	142.1	142.8	0.5%	129.9	10.0%
Europe Fibre Cement	mmsf	194.3	196.5	1.1%	194.3	1.1%
Group Volumes	mmsf	928.1	960.2	3.5%	931.9	3.0%
Revenue						
NA Fibre Cement	US\$m	435.6	459.6	5.5%	459.4	0.0%
APAC Fibre Cement	US\$m	117.3	112.6	-4.0%	102.5	9.9%
Europe	US\$m	87.4	87.9	0.6%	86.3	1.9%
Other Businesses	US\$m	4.3	-	-100.0%	-	nm
Group Revenue	US\$m	644.6	660.1	2.4%	648.2	1.8%
EBIT						
NA Fibre Cement	US\$m	99.5	124.7	25.3%	118.5	5.2%
APAC Fibre Cement	US\$m	27.5	27.0	-1.8%	22.6	19.7%
Europe	US\$m	3.4	5.8	70.6%	8.0	-27.2%
Other Businesses	US\$m	-1.8	-0.5	-72.2%	-	nm
Research & Development	US\$m	-7.1	-6.9	-2.8%	-7.4	-6.4%
Corporate	US\$m	-14.6	-15.9	8.9%	-17.0	-6.5%
Group EBIT (ex. Asbestos)	US\$m	106.9	134.2	25.5%	124.7	7.7%
<i>EBIT Margin</i>	%	16.6%	20.3%		19.2%	
Net Interest (Expense) Revenue	US\$m	-12.9	-14.5	12.4%	-14.1	2.9%
Tax	US\$m	-13.1	-21.1	61.1%	-20.2	4.5%
NPAT pre-abnormals (ex. Asbestos)	US\$m	80.9	98.6	21.9%	90.4	9.1%
EPS pre-abnormals (ex. Asbestos)	UScps	18.3	22.2	21.5%	20.4	8.7%
DPS	UScps	10.0	10.0	-	11.0	-9.1%
<i>Implied Tax Rate</i>	%	13.9%	17.6%		18.3%	
<i>Payout Ratio</i>	%	54.8%	45.1%		53.9%	

Source: Company Reports, Ord Minnett Estimates.

Outlook commentary and guidance

Management expects FY20 adjusted NPAT to be between US\$340-370m. Divisional guidance for FY20 was provided as follows:

- **NAFC:** 4-6% PDG for exteriors; EBIT margin to be between 25-27%;
- **APAC:** Volume growth of 3-5% above market; EBIT margin to be in the top half of the 20%-25% target range; addressable underlying market in Australia anticipated to experience high-single-digit percent contraction in FY20;
- **Europe:** YoY net sales and EBIT margin growth. Addressable underlying market expected to decrease slightly in FY20.

Forecast changes

Our earnings changes following James Hardie's 2Q20 result primarily reflect the following:

- Lower effective tax rate in line with guidance;
- Higher NAFC volume growth and margins in line with guidance;
- Higher APAC volume growth and margins; and
- Further €3m integration costs in 2H20.

Table 2: JHX – Earnings changes

FINANCIAL YEAR	UNITS	FY20	FY21	FY22	3yr AVG
Revenue					
New	US\$m	2,597	2,830	3,082	
Old	US\$m	2,563	2,773	3,021	
<i>Difference %</i>	%	1.3%	2.1%	2.1%	1.8%
EBIT					
New	US\$m	501	569	589	
Old	US\$m	489	551	591	
<i>Difference %</i>	%	2.4%	3.3%	-0.4%	1.8%
NPAT (pre-significant items)					
New	US\$m	365	422	435	
Old	US\$m	354	407	438	
<i>Difference %</i>	%	3.2%	3.7%	-0.6%	2.1%
EPS (pre-significant items)					
New	US\$m	82.6	95.5	98.5	
Old	US\$m	80.0	92.1	99.1	
<i>Difference %</i>	%	3.2%	3.7%	-0.6%	2.1%
DPS					
New	US\$m	41.0	51.0	59.0	
Old	US\$m	40.0	49.0	59.0	
<i>Difference %</i>	%	2.5%	4.1%	-	2.2%

Source: Ord Minnett estimates

Investment Thesis, Valuation and Risks

James Hardie Industries *(Accumulate; Price Target: \$28.50)*

Investment Thesis

Sentiment is understandably very positive towards the stock and expectations for earnings growth continue to rise. We are cognisant that this lifts the hurdle for results to surprise on the upside and also raises the risk of a share price correction if business performance falters. However, James Hardie does not screen expensive – a P/E of 19x (ex. asbestos) is at a discount to its own history and the Industrials index of 22x. On our estimates, this multiple offers shareholders an FY20–22 EPS CAGR of 9%. We retain our Accumulate recommendation and continue to believe James Hardie is an attractive investment within the building materials sector.

Valuation

Our \$28.50 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)	9,494	31.02
APAC Fibre Cement	DCF-based valuation (ex. Changes in working capital and provisions)	1,498	4.89
Europe	DCF-based valuation (ex. Changes in working capital and provisions)	1,029	3.36
Less: Corporate and R&D	DCF-based valuation (incl. Capex, group changes in working capital and provisions)	-2,106	-6.88
Enterprise Value		9,915	32.39
Less: Net Debt	Group net debt as at year-end: FY20	-1,295	-4.23
Less: Asbestos	Based on JHX financial statements at FY20	-356	-1.16
Less: Provisions	Based on JHX financial statements at FY20	-109	-0.36
Estimated equity value	Group SoP valuation	8,155	26.64

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 and 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 dollar.

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	2,597	2,830	3,082	Cash flow from operating activities	302	288	389	415	426
Adj. EBITDA	490	524	631	717	737	o/w Depreciation & amortization	92	119	130	148	148
D&A	(92)	(119)	(130)	(148)	(148)	o/w Changes in working capital	(36)	(51)	(21)	(34)	(28)
Adj. EBIT	398	405	501	569	589	Cash flow from investing activities	(201)	(854)	(201)	(152)	(152)
Net Interest	(31)	(52)	(56)	(53)	(55)	o/w Capital expenditure	(204)	(301)	(201)	(152)	(152)
Adj. PBT	367	353	445	516	534	as % of sales	9.9%	12.0%	7.7%	5.4%	4.9%
Tax	(28)	(72)	(80)	(94)	(98)	Cash flow from financing activities	108	371	(181)	(225)	(261)
Minority Interest	0	0	0	0	0	o/w Dividends paid	(178)	(172)	(181)	(225)	(261)
Adj. Net Income	291	301	365	422	435	o/w Shares issued/(repurchased)	(16)	(6)	0	0	0
Reported EPS	0.33	0.52	0.82	0.95	0.98	o/w Net debt issued/(repaid)	325	542	0	0	0
Adj. EPS	0.66	0.68	0.82	0.95	0.98	Net change in cash	210	(196)	7	37	13
DPS	0.40	0.36	0.41	0.51	0.59	Adj. Free cash flow to firm	131	31	234	306	319
Payout ratio	121.1%	69.7%	49.8%	53.5%	60.0%	y/y Growth	(37.2%)	(76.5%)	656.7%	30.9%	4.3%
Shares outstanding	442	443	443	443	443	Ratio Analysis	FY18A	FY19A	FY20E	FY21E	FY22E
Segmental Earnings						Gross margin	35.5%	33.2%	41.5%	41.9%	40.3%
North America Fibre Cement Revenue	1,578	1,677	1,803	1,994	2,184	EBITDA margin	23.8%	20.9%	24.3%	25.3%	23.9%
EBIT	382	388	469	528	546	EBIT margin	19.3%	16.1%	19.3%	20.1%	19.1%
APAC Revenue	425	447	420	433	463	Net profit margin	14.2%	12.0%	14.1%	14.9%	14.1%
EBIT	108	100	99	102	112	ROE	(134.3%)	79.8%	34.2%	33.6%	30.2%
Europe Revenue	36	368	373	402	435	ROA	13.4%	9.4%	9.0%	10.2%	10.3%
EBIT	0	10	28	41	49	ROCE	59.1%	22.9%	16.8%	17.6%	17.0%
Other Businesses Revenue	15	15	1	0	0	ROIC	32.8%	20.2%	23.9%	26.5%	27.0%
EBIT	(9)	(7)	(0)	0	0	SG&A/Sales	-	-	-	-	-
General Corp ex. Asbestos and ASIC	(56)	(57)	(65)	(68)	(71)	Net debt/Equity	NM	1.3	1.1	0.9	0.8
Research & Development Expenses	(26)	(28)	(29)	(33)	(45)	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	85	123	136	Assets/Equity (x)	NM	8.5	3.8	3.3	2.9
Accounts receivable	203	255	263	287	312	Interest cover (x)	15.6	10.1	11.3	13.5	13.3
Inventories	256	317	327	357	388	Operating leverage	182.3%	8.1%	656.9%	151.7%	39.2%
Other current assets	103	103	103	103	103	Tax rate	20.6%	14.8%	17.9%	18.2%	18.4%
Current assets	843	754	779	870	940	Revenue y/y Growth	6.9%	22.0%	3.6%	8.9%	8.9%
PP&E	992	1,388	1,459	1,463	1,467	EBITDA y/y Growth	12.2%	7.0%	20.5%	13.5%	2.8%
LT investments	-	-	-	-	-	EPS y/y Growth	18.2%	3.0%	21.4%	15.7%	3.2%
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	4,113	4,193	4,252	P/E (x)	27.8	27.0	22.2	19.2	18.6
Short term borrowings	0	0	0	0	0	P/BV (x)	NM	8.3	7.0	6.0	5.3
Payables	193	256	253	272	302	EV/EBITDA (x)	17.8	18.0	15.0	13.1	12.8
Other short term liabilities	201	228	228	228	228	Dividend Yield	2.2%	2.0%	2.2%	2.8%	3.2%
Current liabilities	395	483	481	500	530	FX	FY18A	FY19A	FY20E	FY21E	FY22E
Long-term debt	884	1,380	1,380	1,380	1,380	USDAUD	1.29	1.37	1.44	1.44	1.44
Other long term liabilities	1,294	1,195	1,094	958	813	USDEUR	0.86	0.86	0.90	0.89	0.88
Total liabilities	2,573	3,058	2,955	2,838	2,723	North America Key Metrics	FY18A	FY19A	FY20E	FY21E	FY22E
Shareholders' equity	(222)	974	1,158	1,355	1,530	Volume Growth	1.1%	3.1%	6.2%	8.4%	6.9%
Minority interests	0	0	0	0	0	PDG (Exteriors)	(3.0%)	0.6%	5.5%	6.0%	5.0%
Total liabilities & equity	2,351	4,033	4,113	4,193	4,252	Price increase	5.0%	2.9%	1.5%	2.0%	2.5%
BVPS	(0.50)	2.20	2.61	3.06	3.45	NA EBIT Margin	24.2%	23.1%	26.0%	26.5%	25.0%
y/y Growth	4.8%	(539.2%)	18.8%	17.1%	12.9%	Net debt/(cash)	603	1,302	1,295	1,258	1,244

Source: Company reports and Ord Minnett estimates.

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

Please contact your Ord Minnett Adviser for further information on our document.

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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