

# Steel & Tube Holdings

**NEUTRAL**

## FY19 Result — Margins Not Made of Steel; Upgrade to NEUTRAL

Steel & Tube's (STU) FY19 result rounds out yet another disappointing year for shareholders. EBIT came in -35% below the guidance that supported its equity raising, and the stock price is now less than half the NZ\$1.90/share takeover offer rejected by the board. STU has attributed the earnings miss to external market factors. There is no doubt competition is impacting margins across the industry, but with industry players pointing fingers in different directions, it is difficult to be certain who are the chief antagonists. STU remains an inherently high risk, but with the share price at a >25 year low, we view the medium-term investment proposition as balanced; upgrade to NEUTRAL.

### Another challenging year

STU's FY19 came in toward the lower end of May's guidance. Whilst operating earnings saw a modest lift on FY18's *annus horribilis*, EBIT and underlying EPS are -48% and -71% below FY17 respectively. The principal impact has been lower gross margin, down 1.5ppt yoy and 2.5ppt vs. FY17. STU is a high operating leverage business in a competitive industry; a +/-1ppt change in gross margin has a +/-NZ\$5m impact on EBIT which equates to c.30% of FY19. That being said, the level in FY19 is by no means unprecedented, and is in fact +0.1ppt ahead of the 10-year median.

### He said, she said

STU attributed the difficult year to "challenging" market conditions, including a decline in some sectors, notably stainless c.-20% (where demand is dominated by dairy and viticulture), and competitive pressure on price. It is difficult to confidently ascertain who is/are the principal instigator(s) of the greater competitive intensity. Some industry players point to STU's pursuit of market share; STU rejects this notion. What is clear is that STU has not been the only company impacted. Fletcher Building's Steel division's FY19 EBIT was down -33%, or, we estimate, -55% excluding its steel coating business (an industry in which STU does not operate).

### Inherent uncertainty

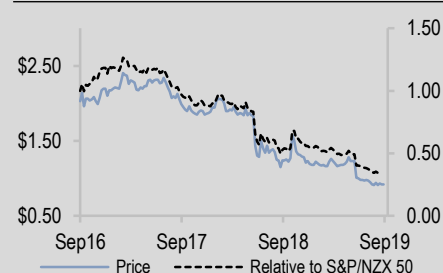
STU was, understandably in our view, reluctant to provide any guidance for FY20. The company's leverage to volatile demand and margins is substantial, it is early in the year, and forward visibility on these factors is limited. Additionally, (1) anecdotally, competitive pressures remain considerable, and (2) demand in segments such as vertical construction and stainless appears to be easing. Furthermore, whilst STU believes it has made significant progress on its internal "Project Strive" initiatives to improve customer service and operating efficiency, tangible evidence remains limited. While all these factors mean we have little confidence in a material near-term improvement in STU's performance, we also recognise the pendulum can swing quickly. With the market factoring in a continuation of difficult conditions, any easing in competitive intensity would likely benefit both earnings and the share price.

### Investment View

We upgrade to NEUTRAL. With the stock price at a >25-year low we view the risk-reward as more balanced. Whilst we expect (and the market is factoring in) a continuation of difficult conditions, the pendulum can swing quickly, and STU's sensitivity to any improved backdrop is substantial.

NZX Code	STU
Share price	NZ\$0.92
Target price	NZ\$1.00
Risk rating	High
Issued shares	162.5m
Market cap	NZ\$149m
Average daily turnover	303.7k (NZ\$420k)

### Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ\$m)	10.0	11.5	16.5	17.3
EPS* (NZc)	6.5	7.1	10.2	10.7
EPS growth* (%)	-36.6	8.2	44.0	5.1
DPS (NZc)	5.0	5.0	7.0	7.0
Imputation (%)	100	100	100	100

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	8.8	6.4	5.2	5.0
EV/EBIT	12.8	9.1	6.9	6.6
PE	14.1	13.0	9.1	8.6
Price / NTA	0.8	0.7	0.7	n/a
Cash dividend yield (%)	5.4	5.4	7.6	7.6
Gross dividend yield (%)	7.5	7.5	10.6	10.6

\*Historic and forecast numbers based on underlying profits

### Matt Henry, CFA

matt.henry@forsythbarr.co.nz  
+64 9 368 0115

### Matt Dunn

matt.dunn@forsythbarr.co.nz  
+64 9 368 0103

**Steel & Tube Holdings Limited (STU)**

Priced as at 23 Aug 2019: NZ\$0.92

June year end

<b>Forsyth Barr valuation</b>						<b>Valuation Ratios</b>					2018A	2019A	2020E	2021E	2022E
Valuation methodology						DCF, sector peer relative, market relative					n/a	8.8	6.4	5.2	5.0
<b>12-month target price (NZ\$)*</b>						<b>Spot valuations (NZ\$)</b>					n/a	12.8	9.1	6.9	6.6
Expected share price return	8.7%	1. DCF	1.26			EV/EBITDA (x)					8.9	14.1	13.0	9.1	8.6
Net dividend yield	5.8%	2. Sector peer relative	0.73			EV/EBIT (x)					0.7	0.8	0.7	0.7	0.7
Estimated 12-month return	14.5%	3. Market relative	1.43			PE (x)					0.7	0.8	0.7	0.7	0.7
<b>Key WACC assumptions</b>						<b>DCF valuation summary (NZ\$m)</b>					-11.8	9.6	7.1	7.9	8.6
Risk free rate	2.00%	Total firm value	219			Price/NTA (x)					7.6	5.4	5.4	7.6	7.6
Equity beta	1.50	(Net debt)/cash	(15)			Free cash flow yield (%)					10.0	7.5	7.5	10.6	10.6
WACC	9.6%	Value of equity	204			Net dividend yield (%)					81	100	100	100	100
Terminal growth	1.5%	Shares (m)	0			Gross dividend yield (%)					68	77	71	69	66
<b>Profit and Loss Account (NZ\$m)</b>						<b>Capital Structure</b>					2018A	2019A	2020E	2021E	2022E
Sales revenue	496.8	499.1	500.2	513.9	527.4	Interest cover EBIT (x)					n/a	5.8	9.8	86.8	>100x
<b>Normalised EBITDA</b>	<b>(9.5)</b>	<b>23.6</b>	<b>25.5</b>	<b>30.7</b>	<b>31.6</b>	Interest cover EBITDA (x)					n/a	8.4	14.1	>100x	>100x
Depreciation and amortisation	(8.1)	(7.3)	(7.8)	(7.5)	(7.3)	Net debt/ND+E (%)					37.7	5.6	3.7	2.9	2.3
<b>Normalised EBIT</b>	<b>(17.5)</b>	<b>16.3</b>	<b>17.7</b>	<b>23.2</b>	<b>24.3</b>	Net debt/EBITDA (x)					n/a	0.6	0.4	0.3	0.2
Net interest	(4.6)	(2.8)	(1.8)	(0.3)	(0.2)	<b>Key Ratios</b>					2018A	2020E	2021E	2022E	
Associate income	-	-	-	-	-	Return on assets (%)					-5.2	5.1	5.4	7.0	7.2
Tax	8.8	(3.6)	(4.5)	(6.4)	(6.7)	Return on equity (%)					5.2	3.9	4.4	6.2	6.4
Minority interests	-	-	-	-	-	Return on funds employed (%)					-4.0	4.1	4.6	6.1	6.3
<b>Normalised NPAT</b>	<b>9.0</b>	<b>10.0</b>	<b>11.5</b>	<b>16.5</b>	<b>17.3</b>	EBITDA margin (%)					-1.9	4.7	5.1	6.0	6.0
Abnormals/other	18.7	(0.5)	-	-	-	EBIT margin (%)					-3.5	3.3	3.5	4.5	4.6
<b>Reported NPAT</b>	<b>(32.1)</b>	<b>10.4</b>	<b>11.5</b>	<b>16.5</b>	<b>17.3</b>	Capex to sales (%)					3.8	1.4	1.4	1.4	1.4
Normalised EPS (cps)	10.3	6.5	7.1	10.2	10.7	Capex to depreciation (%)					313	150	151	147	144
DPS (cps)	7.0	5.0	5.0	7.0	7.0	<b>Operating Performance</b>					2018A	2019A	2020E	2021E	2022E
<b>Growth Rates</b>						<b>Operating revenue</b>					<b>495.8</b>	<b>498.1</b>	<b>499.2</b>	<b>512.9</b>	<b>526.3</b>
Revenue (%)	-3.2	0.5	0.2	2.8	2.6	Cost of sales					398.4	387.1	386.9	394.9	405.3
EBITDA (%)	n/a	n/a	7.9	20.5	3.0	<b>Gross margin</b>					<b>97.4</b>	<b>111.0</b>	<b>112.3</b>	<b>118.0</b>	<b>121.1</b>
EBIT (%)	n/a	n/a	8.5	30.9	4.8	Gross margin %					19.6%	22.3%	22.5%	23.0%	23.0%
Normalised NPAT (%)	-54.6	11.2	15.1	44.0	5.1	Other revenue					1.0	1.0	1.0	1.0	1.0
Normalised EPS (%)	-54.6	-36.6	8.2	44.0	5.1	<b>Expenses</b>									
DPS (%)	-56.3	-28.6	0.0	40.0	0.0	Selling					45.3	37.4	36.9	37.3	38.5
<b>Cash Flow (NZ\$m)</b>						Administration					40.2	33.2	33.2	33.2	33.8
<b>EBITDA</b>	<b>(9.5)</b>	<b>23.6</b>	<b>25.5</b>	<b>30.7</b>	<b>31.6</b>	Other					30.4	25.1	25.5	25.3	25.5
Working capital change	16.6	(0.2)	(1.4)	(4.9)	(4.3)	<b>Total expenses</b>					<b>115.9</b>	<b>95.6</b>	<b>95.6</b>	<b>95.8</b>	<b>97.8</b>
Interest & tax paid	1.5	2.3	(6.3)	(6.7)	(7.0)	<b>EBIT</b>					<b>-17.5</b>	<b>16.4</b>	<b>17.7</b>	<b>23.2</b>	<b>24.3</b>
Other	(7.3)	(4.4)	-	-	-	EBIT margin %					-3.5%	3.3%	3.6%	4.5%	4.6%
<b>Operating cash flow</b>	<b>1.3</b>	<b>21.3</b>	<b>17.8</b>	<b>19.1</b>	<b>20.3</b>	<b>Expenses % of sales</b>									
Capital expenditure	(19.0)	(7.0)	(7.1)	(7.3)	(7.4)	Selling					9.1%	7.5%	7.4%	7.3%	7.3%
(Acquisitions)/divestments	52.8	2.3	-	-	-	Administration					8.1%	6.7%	6.6%	6.5%	6.4%
Other	-	-	-	-	-	Other					6.1%	5.0%	5.1%	4.9%	4.8%
<b>Funding available/(required)</b>	<b>35.1</b>	<b>16.6</b>	<b>10.6</b>	<b>11.9</b>	<b>12.9</b>	<b>Total expenses</b>					<b>23.4%</b>	<b>19.2%</b>	<b>19.1%</b>	<b>18.7%</b>	<b>18.6%</b>
Dividends paid	(12.7)	(5.9)	(5.7)	(9.7)	(11.4)	<b>Balance Sheet (NZ\$m)</b>					2018A	2019A	2020E	2021E	2022E
Equity raised/(returned)	0.0	78.8	-	-	-	Working capital					165.4	163.6	164.8	169.8	174.2
<b>Increase/(decrease) in net debt</b>	<b>(22.5)</b>	<b>(89.5)</b>	<b>(5.0)</b>	<b>(2.1)</b>	<b>(1.5)</b>	Fixed assets					52.7	52.0	54.4	56.8	59.0
<b>Balance Sheet (NZ\$m)</b>						Intangibles					57.4	56.9	53.9	51.3	49.2
Working capital	165.4	163.6	164.8	169.8	174.2	Other assets					2.9	0.1	0.1	0.1	0.1
Fixed assets	52.7	52.0	54.4	56.8	59.0	<b>Total funds employed</b>					<b>278.4</b>	<b>272.7</b>	<b>273.2</b>	<b>278.0</b>	<b>282.5</b>
Intangibles	57.4	56.9	53.9	51.3	49.2	Net debt/(cash)					104.4	15.0	10.0	7.9	6.4
Other assets	2.9	0.1	0.1	0.1	0.1	Other non current liabilities					13.1	7.2	6.9	7.0	7.1
<b>Total funds employed</b>	<b>278.4</b>	<b>272.7</b>	<b>273.2</b>	<b>278.0</b>	<b>282.5</b>	Shareholder's funds					172.6	253.9	259.7	266.4	272.4
Net debt/(cash)	104.4	15.0	10.0	7.9	6.4	Minority interests					-	-	-	-	-
Other non current liabilities	13.1	7.2	6.9	7.0	7.1	<b>Total funding sources</b>					<b>290.1</b>	<b>276.1</b>	<b>276.6</b>	<b>281.4</b>	<b>285.9</b>
Shareholder's funds	172.6	253.9	259.7	266.4	272.4										
Minority interests	-	-	-	-	-										
<b>Total funding sources</b>	<b>290.1</b>	<b>276.1</b>	<b>276.6</b>	<b>281.4</b>	<b>285.9</b>										

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

## Result analysis

Figure 1. 1H19 result analysis

NZ\$m	FY18	FY19	% chg	Forbar	% diff	
Revenue	496.8	499.1	0.5%	523.3	-4.6%	+5% excluding exited S&T Plastics. Distribution flat, includes Stainless down c.-20%. Infrastructure division +13%.
Cost of sales	(398.4)	(387.1)	-2.8%	(407.5)	-5.0%	
Gross margin	98.4	111.9	13.8%	115.8	-3.3%	
Gross margin %	19.8%	22.4%	13.2%	22.1%	1.4%	FY18 23.7% excl. inventory write downs. STU attributes the decline principally to increased competitive intensity. Industry anecdotes suggest that STU has been aggressive in the pursuit of market share; albeit STU refutes this view.
Operating expenses						Benefit from cost savings, significant one-off factors in pcp, and S&T plastics exit.
	(107.9)	(88.3)	-18.1%	(91.4)	-3.4%	
EBITDA						Lower due to the FY18 impairment of property, plant, equipment and intangibles.
	(9.5)	23.6	na	24.4	-3.1%	
Depreciation & amortisation	(8.1)	(7.3)	-9.6%	(7.3)	-0.4%	
EBIT	(17.5)	16.3	na	17.1	-4.2%	
Abnormal items	(18.7)	0.5	na	0.0	nm	
EBIT	(36.2)	16.8	na	17.1	-1.6%	
Interest	(4.6)	(2.8)	-38.9%	(3.5)	-20.1%	Lower debt post equity raising.
Net profit before tax	(40.8)	14.0	na	13.5	3.3%	
Tax	8.8	(3.6)	na	(3.8)	-6.2%	
Net profit after tax	(32.1)	10.4	na	9.7	7.0%	
Underlying NPAT	9.0	10.0	11.2%	9.7	2.3%	
Underlying EPS (cps)	10.3	6.5	-36.6%	6.4	2.3%	Diluted by equity raising.
Dividend (cps)	7.0	5.0	-28.6%	5.0	0.0%	

Source: Forsyth Barr analysis

## Earnings revisions

Minor changes to earnings, albeit margin of error remains substantial.

Figure 2. Earnings revisions

NZ\$m	FY20E			FY21E			FY22E
	Old	New	% chg	Old	New	% chg	New
Revenue	524.4	500.2	-4.6%	538.8	513.9	-4.6%	527.4
EBIT	18.1	17.7	-2.3%	23.7	23.2	-2.0%	24.3
Adjusted NPAT	11.6	11.5	-1.0%	16.6	16.5	-0.8%	17.3
Adjusted EPS (cps)	7.1	7.1	-1.0%	10.3	10.2	-0.9%	10.7
Dividend (cps)	6.0	5.0	-16.7%	8.0	7.0	-12.5%	7.0

Source: Forsyth Barr analysis

## Investment summary

We rate Steel & Tube (STU) as **NEUTRAL**. With the stock price at a >25-year low we view the risk-reward as more balanced. Whilst we expect (and the market is factoring in) a continuation of difficult conditions, the pendulum can swing quickly, and STU's sensitivity to any improved backdrop is substantial.

### Business quality

- **Intense industry competition:** STU operates in a fragmented and highly competitive industry. For an extended period (pre-FY19) STU shed material market share in its core distribution business principally, in our view, due to customer service deficiencies. This appears to have been checked in FY19, but at a cost to margins. STU's inherently high leverage to inputs (incl. revenue and margins) results in considerable uncertainty over its long-term earnings outlook and valuation.

### Earnings and cash flow outlook

- **Management optimism not yet reflected in the financials:** STU's refreshed board and management have launched a change programme focussed on improved customer service and efficiency. These initiatives underpin ambitious medium-term earnings growth targets (EBIT FY21 NZ\$35–40m *cf.* FY19E NZ\$17m). Difficulty in estimating the potential for turnaround success compounds the inherently high forecasting margin of error for STU. The number and magnitude of profit warnings in recent years emphasises that management's optimism be approached with a high degree of caution.

### Financial structure

- **Recapped balance sheet:** STU recently recapitalised its balance sheet with an NZ\$81m equity raising. Headline balance sheet metrics have improved significantly to 0.6x FY19 net debt/EBITDA; however, underlying gearing remains full given its considerable off balance sheet debt. Capitalising operating leases at 6% FY19 net debt/EBITDA remains at an elevated 7.5x.

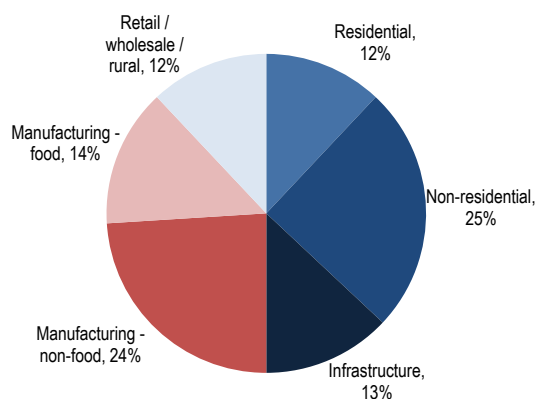
### Risks factors

- **Execution of turnaround initiatives.**
- **Competitive pressures on market share and margins.**
- **Domestic steel demand:** Demand for STU's products is impacted by cyclical construction and manufacturing activity, and volatile commodity prices.
- **Steel prices:** Global steel prices are inherently volatile, and can impact short-term margins and the industry profit pool.

### Company description

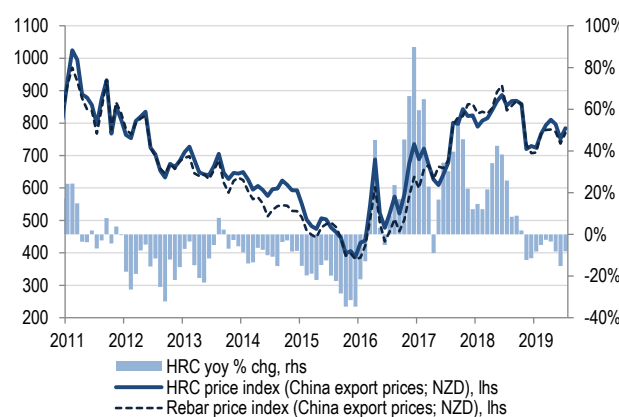
STU is NZ's largest steel distribution company with customers across the construction, manufacturing and rural sectors. It operates a nationwide network of >50 branches and distribution centres across its steel distribution, steel processing (eg. rollforming, reinforcing), stainless steel, fasteners and plastic pipes businesses. In recent time STU has acquired four businesses: Tata Steel (stainless steel), Fortress Fasteners (fasteners), Aquaduct and Bosch Irrigation (polyethylene pipes and irrigation) and Composite Floor Decks (distributor and installer of steel floor decking systems).

Figure 3. STU sector exposure (FY19)



Source: Company reports, Forsyth Barr analysis

Figure 4. Global steel prices



Source: Company reports, Forsyth Barr analysis

**Figure 5. Substantial Shareholders**

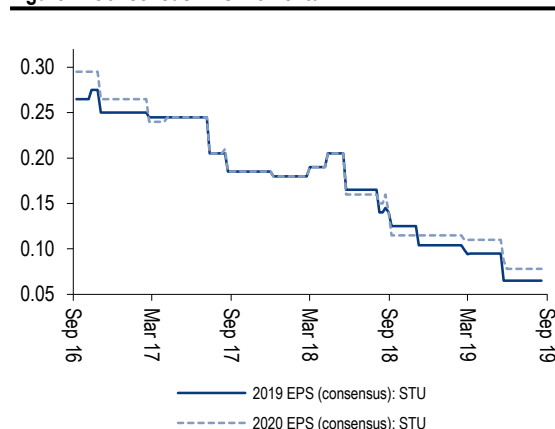
Shareholder	Latest Holding
New Zealand Steel Limited	15.8%

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

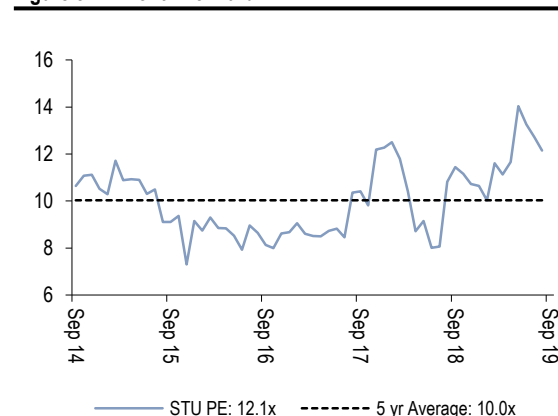
**Figure 6. International Compcos**

Company	Code	Price	Mkt Cap	PE	EV/EBITDA	EV/EBIT	Cash D/Yld
<i>(metrics re-weighted to reflect STU's balance date - June)</i>							
<b>Steel &amp; Tube Holdings</b>	<b>STU NZ</b>	<b>NZ\$0.92</b>	<b>NZ\$149</b>	<b>13.0x</b>	<b>9.1x</b>	<b>6.5x</b>	<b>5.4x</b>
Fletcher Building *	FBU NZ	NZ\$4.65	NZ\$3,968	13.1x	12.6x	6.1x	5.9x
Metro Performance Glass *	MPG NZ	NZ\$0.30	NZ\$55	3.7x	4.0x	3.6x	3.9x
Adelaide Brighton	ABC AT	A\$3.12	A\$2,033	15.7x	15.1x	9.0x	8.8x
Boral	BLD AT	A\$4.98	A\$5,838	12.0x	12.1x	7.8x	7.6x
BlueScope Steel	BSL AT	A\$12.42	A\$6,384	13.0x	10.4x	5.0x	4.3x
CSR	CSR AT	A\$4.00	A\$1,992	14.0x	14.3x	7.4x	7.6x
DuluxGroup	DLX AT	A\$9.35	A\$3,639	24.6x	23.8x	15.6x	15.2x
GWA Group	GWA AT	A\$3.25	A\$858	15.4x	14.8x	10.8x	10.4x
James Hardie Industries PLC	JHX AT	US\$15.63	US\$6,913	19.1x	17.0x	13.0x	11.8x
Reece	REH AT	A\$10.23	A\$5,737	21.4x	20.7x	10.4x	10.1x
Sims Metal Management	SGM AT	A\$9.52	A\$1,930	12.0x	11.1x	5.0x	4.7x
<b>Compcos Average:</b>				<b>14.9x</b>	<b>14.2x</b>	<b>8.5x</b>	<b>8.2x</b>
<b>STU Relative:</b>				<b>-13%</b>	<b>-36%</b>	<b>-24%</b>	<b>-35%</b>
<b>EV = Current Market Cap + Actual Net Debt</b>							
						<b>11.3x</b>	<b>10.9x</b>
						<b>-18%</b>	<b>-35%</b>
							<b>+54%</b>

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

**Figure 7. Consensus EPS Momentum**


Source: Forsyth Barr analysis, Bloomberg

**Figure 8. 12 Month Forward PE**


Source: Forsyth Barr analysis

**Not personalised financial advice:** The recommendations and opinions in this publication do not take into account your personal financial situation or investment goals. The financial products referred to in this publication may not be suitable for you. If you wish to receive personalised financial advice, please contact your Forsyth Barr Investment Adviser. The value of financial products may go up and down and investors may not get back the full (or any) amount invested. Past performance is not necessarily indicative of future performance. Disclosure statements for Forsyth Barr Investment Advisers are available on request and free of charge. **Disclosure:** Forsyth Barr Limited and its related companies (and their respective directors, officers, agents and employees) ("Forsyth Barr") may have long or short positions or otherwise have interests in the financial products referred to in this publication, and may be directors or officers of, and/or provide (or be intending to provide) investment banking or other services to, the issuer of those financial products (and may receive fees for so acting). Forsyth Barr is not a registered bank within the meaning of the Reserve Bank of New Zealand Act 1989. Forsyth Barr may buy or sell financial products as principal or agent, and in doing so may undertake transactions that are not consistent with any recommendations contained in this publication. Forsyth Barr confirms no inducement has been accepted from the researched entity, whether pecuniary or otherwise, in connection with making any recommendation contained in this publication. **Analyst Disclosure Statement:** In preparing this publication the analyst(s) may or may not have a threshold interest in the financial products referred to in this publication. For these purposes a threshold interest is defined as being a holder of more than \$50,000 in value or 1% of the financial products on issue, whichever is the lesser. In preparing this publication, non-financial assistance (for example, access to staff or information) may have been provided by the entity being researched. **Disclaimer:** This publication has been prepared in good faith based on information obtained from sources believed to be reliable and accurate. However, that information has not been independently verified or investigated by Forsyth Barr. Forsyth Barr does not make any representation or warranty (express or implied) that the information in this publication is accurate or complete, and, to the maximum extent permitted by law, excludes and disclaims any liability (including in negligence) for any loss which may be incurred by any person acting or relying upon any information, analysis, opinion or recommendation in this publication. Forsyth Barr does not undertake to keep current this publication; any opinions or recommendations may change without notice. Any analyses or valuations will typically be based on numerous assumptions; different assumptions may yield materially different results. Nothing in this publication should be construed as a solicitation to buy or sell any financial product, or to engage in or refrain from doing so, or to engage in any other transaction. Other Forsyth Barr business units may hold views different from those in this publication; any such views will generally not be brought to your attention. This publication is not intended to be distributed or made available to any person in any jurisdiction where doing so would constitute a breach of any applicable laws or regulations or would subject Forsyth Barr to any registration or licensing requirement within such jurisdiction. **Terms of use:** Copyright Forsyth Barr Limited. You may not redistribute, copy, revise, amend, create a derivative work from, extract data from, or otherwise commercially exploit this publication in any way. By accessing this publication via an electronic platform, you agree that the platform provider may provide Forsyth Barr with information on your readership of the publications available through that platform.