

# Steel & Tube Holdings

OUTPERFORM

## Priced for Permanent Purgatory; Upgrade to OUTPERFORM

For a long time now Steel & Tube (STU) has been a perennial and very expensive disappointment for investors. It is understandable the market is pricing in a continuation of depressed earnings and returns; there has been little evidence the board and management team has the capability to turn the company's performance around. However, in our opinion, (1) the share price encompasses this adverse view, (2) competitive intensity is negatively impacting all players across the industry, (3) STU is highly levered to any easing in these competitive pressures, and (4) at 0.6x P/NTA others may be considering if they can run the business more effectively. We view STU as a high risk investment, but at current levels regard the risk-reward as positive. Upgrade to OUTPERFORM.

### What's changed?

- **Earnings:** EPS FY20E/21E/22E -16%/-16%/-18%, always with a high margin of error attached.
- **Target Price:** Lowered to NZ\$1.05.

### Another year, another downgrade

STU has advised "that adverse trading conditions are continuing" and it expects its 1H20 performance to be down yoy. It remains perennially optimistic further out: "improvements we have made to customer service and cost structure, coupled together with recent signs of activity improvement, are expected to lead to improved performance in the 2H".

Key 1H impacts include: (1) NZ\$2m of "Project Strive" costs (STU's programme to improve customer service and operating efficiency), (2) NZ\$2m in bad/doubtful debts — not overly surprising given the stress we have seen across the construction sector, (3) a continuation of competitive restraint on margins, and (4) softer market activity, particularly in vertical construction, and stainless steel (largely due to reduced dairy conversions).

### Market has every right to spurn STU; pessimism priced in

It has been a cheerless few years for STU's shareholders. We can understand why the market is pricing in zero benefit from self-help initiatives or any easing in competitive pressures. That said, at current share price levels we believe the risk-reward has become positively asymmetric. Whilst STU is likely past peak cycle demand, we do not expect the downturn to be dramatic. Project Strive and bad/doubtful debt costs should not reoccur. No benefit from Project Strive is being priced in. Other players across the industry are also being impacted by competition (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). STU is highly levered to any easing in competition — a +/-1ppt change in gross margin impacts EBIT by +/-NZ\$5m or c.26% of FY20E. At a P/NTA of 0.6x, reflecting the meagre 2% return of assets and 4% return on equity, others may be considering if they can run the business more effectively (albeit addressing NZ Steel's 15.8% stake would be necessary).

### Investment View

We upgrade to OUTPERFORM. With the stock price at a >25-year low, in our view, it is being priced for permanent purgatory. STU's sensitivity to any operational improvements or easing in competitive intensity is substantial. At current levels we view the risk-reward as positive.

NZX Code	STU
Share price	NZ\$0.79
Target price	NZ\$1.05
Risk rating	High
Issued shares	162.5m
Market cap	NZ\$128m
Average daily turnover	154.4k (NZ\$165k)

### Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ\$m)	10.0	9.6	13.8	14.2
EPS* (NZc)	6.5	5.9	8.5	8.7
EPS growth* (%)	-36.6	-9.2	44.0	2.6
DPS (NZc)	5.0	4.0	6.0	6.0
Imputation (%)	100	100	100	100

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	8.0	6.2	5.2	5.1
EV/EBIT	11.5	9.3	7.1	7.0
PE	12.1	13.3	9.3	9.0
Price / NTA	0.7	0.6	0.6	n/a
Cash dividend yield (%)	6.3	5.1	7.6	7.6
Gross dividend yield (%)	8.8	7.0	10.5	10.5

\*Historic and forecast numbers based on underlying profits

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**Steel & Tube Holdings Limited (STU)** Priced as at 18 Nov 2019: NZ\$0.79

June year end

Forsyth Barr valuation					Valuation Ratios						
Valuation methodology					2018A 2019A 2020E 2021E 2022E						
DCF, sector peer relative, market relative					EV/EBITDA (x)	n/a	8.0	6.2	5.2	5.1	
					EV/EBIT (x)	n/a	11.5	9.3	7.1	7.0	
<b>12-month target price (NZ\$)*</b>	<b>1.05</b>	<b>Spot valuations (NZ\$)</b>			PE (x)	7.7	12.1	13.3	9.3	9.0	
Expected share price return	32.9%	1. DCF		0.99	Price/NTA (x)	0.6	0.7	0.6	0.6	0.6	
Net dividend yield	6.1%	2. Sector peer relative		0.83	Free cash flow yield (%)	-13.7	11.1	7.7	7.9	8.3	
Estimated 12-month return	39.0%	3. Market relative		1.28	Net dividend yield (%)	8.9	6.3	5.1	7.6	7.6	
					Gross dividend yield (%)	11.6	8.8	7.0	10.5	10.5	
<b>Key WACC assumptions</b>					<b>DCF valuation summary (NZ\$m)</b>						
Risk free rate	2.00%	Total firm value			176	<b>Capital Structure</b>					
Equity beta	1.50	(Net debt)/cash			(15)	2018A	2019A	2020E	2021E	2022E	
WACC	9.6%	Value of equity			161	Interest cover EBIT (x)	n/a	5.8	8.3	72.6	>100x
Terminal growth	1.5%	Shares (m)			0	Interest cover EBITDA (x)	n/a	8.4	12.6	>100x	>100x
					<b>Profit and Loss Account (NZ\$m)</b>						
					2018A	2019A	2020E	2021E	2022E		
Sales revenue	496.8	499.1	497.7	508.9	519.6	<b>Net debt/ND+E (%)</b>					
<b>Normalised EBITDA</b>	<b>(9.5)</b>	<b>23.6</b>	<b>22.9</b>	<b>27.0</b>	<b>27.3</b>	<b>Net debt/EBITDA (x)</b>					
Depreciation and amortisation	(8.1)	(7.3)	(7.8)	(7.5)	(7.3)						
<b>Normalised EBIT</b>	<b>(17.5)</b>	<b>16.3</b>	<b>15.2</b>	<b>19.5</b>	<b>19.9</b>	<b>Key Ratios</b>					
Net interest	(4.6)	(2.8)	(1.8)	(0.3)	(0.2)	2018A	2019A	2020E	2021E	2022E	
Associate income	-	-	-	-	-	Return on assets (%)	-5.2	5.1	4.7	5.9	5.9
Tax	8.8	(3.6)	(3.7)	(5.4)	(5.5)	Return on equity (%)	5.2	3.9	3.7	5.2	5.3
Minority interests	-	-	-	-	-	Return on funds employed (%)	-4.0	4.1	3.9	5.2	5.2
<b>Normalised NPAT</b>	<b>9.0</b>	<b>10.0</b>	<b>9.6</b>	<b>13.8</b>	<b>14.2</b>	EBITDA margin (%)	-1.9	4.7	4.6	5.3	5.2
Abnormals/other	18.7	(0.5)	-	-	-	EBIT margin (%)	-3.5	3.3	3.0	3.8	3.8
<b>Reported NPAT</b>	<b>(32.1)</b>	<b>10.4</b>	<b>9.6</b>	<b>13.8</b>	<b>14.2</b>	Capex to sales (%)	3.8	1.4	1.4	1.4	1.4
Normalised EPS (cps)	10.3	6.5	5.9	8.5	8.7	Capex to depreciation (%)	313	150	151	147	144
DPS (cps)	7.0	5.0	4.0	6.0	6.0	<b>Operating Performance</b>					
					2018A	2019A	2020E	2021E	2022E		
					<b>Operating revenue</b>						
					495.8	498.1	496.7	507.9	518.6		
					<b>Cost of sales</b>						
					398.4	387.1	385.0	393.6	401.9		
					<b>Gross margin</b>						
					97.4	111.0	111.8	114.3	116.7		
					<b>Gross margin %</b>						
					19.6%	22.3%	22.5%	22.5%	22.5%		
					<b>Other revenue</b>						
					1.0	1.0	1.0	1.0	1.0		
					<b>Expenses</b>						
					<b>Selling</b>						
					45.3	37.4	36.9	37.3	38.5		
					<b>Administration</b>						
					40.2	33.2	33.2	33.2	33.8		
					<b>Other</b>						
					30.4	25.1	25.5	25.3	25.5		
					<b>Total expenses</b>						
					115.9	95.6	95.6	95.8	97.8		
					<b>EBIT</b>						
					-17.5	16.4	17.2	19.5	19.9		
					<b>EBIT margin %</b>						
					-3.5%	3.3%	3.5%	3.8%	3.8%		
					<b>Expenses % of sales</b>						
					<b>Selling</b>						
					9.1%	7.5%	7.4%	7.4%	7.4%		
					<b>Administration</b>						
					8.1%	6.7%	6.7%	6.5%	6.5%		
					<b>Other</b>						
					6.1%	5.0%	5.1%	5.0%	4.9%		
					<b>Total expenses</b>						
					23.4%	19.2%	19.2%	18.9%	18.9%		
<b>Cash Flow (NZ\$m)</b>					2018A	2019A	2020E	2021E	2022E		
<b>EBITDA</b>					(9.5)	23.6	22.9	27.0	27.3		
Working capital change					16.6	(0.2)	(0.4)	(4.0)	(3.4)		
Interest & tax paid					1.5	2.3	(5.6)	(5.7)	(5.7)		
Other					(7.3)	(4.4)	-	-	-		
<b>Operating cash flow</b>					<b>1.3</b>	<b>21.3</b>	<b>17.0</b>	<b>17.4</b>	<b>18.1</b>		
Capital expenditure					(19.0)	(7.0)	(7.1)	(7.3)	(7.4)		
(Acquisitions)/divestments					52.8	2.3	-	-	-		
Other					-	-	-	-	-		
<b>Funding available/(required)</b>					<b>35.1</b>	<b>16.6</b>	<b>9.8</b>	<b>10.1</b>	<b>10.7</b>		
Dividends paid					(12.7)	(5.9)	(5.7)	(6.5)	(9.7)		
Equity raised/(returned)					0.0	78.8	-	-	-		
<b>Increase/(decrease) in net debt</b>					<b>(22.5)</b>	<b>(89.5)</b>	<b>(4.1)</b>	<b>(3.6)</b>	<b>(0.9)</b>		
<b>Balance Sheet (NZ\$m)</b>					2018A	2019A	2020E	2021E	2022E		
Working capital					165.4	163.6	163.8	167.8	171.3		
Fixed assets					52.7	52.0	54.4	56.8	59.0		
Intangibles					57.4	56.9	53.9	51.3	49.2		
Other assets					2.9	0.1	0.1	0.1	0.1		
<b>Total funds employed</b>					<b>278.4</b>	<b>272.7</b>	<b>272.2</b>	<b>276.0</b>	<b>279.6</b>		
Net debt/(cash)					104.4	15.0	10.8	7.2	6.3		
Other non current liabilities					13.1	7.2	6.9	7.0	7.1		
Shareholder's funds					172.6	253.9	257.8	265.2	269.6		
Minority interests					-	-	-	-	-		
<b>Total funding sources</b>					<b>290.1</b>	<b>276.1</b>	<b>275.6</b>	<b>279.4</b>	<b>283.0</b>		

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

## Investment summary

We rate Steel & Tube (STU) as **OUTPERFORM**. With the stock price at a >25-year low, in our view, it is being priced for permanent purgatory. STU's sensitivity to any operational improvements or easing in competitive intensity is substantial. At current levels we view the risk-reward as positive.

### 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 NZ\$30–25m *cf.* FY19 NZ\$16m). 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:** Last financial year STU recently recapitalised its balance sheet with an NZ\$81m equity raising. Headline balance sheet metrics have improved significantly to 0.5x FY20E net debt/EBITDA. Underlying gearing remains full given its considerable off balance sheet debt. Capitalising operating leases at 6% FY20E net debt/EBITDA remains at an elevated 7.6x.

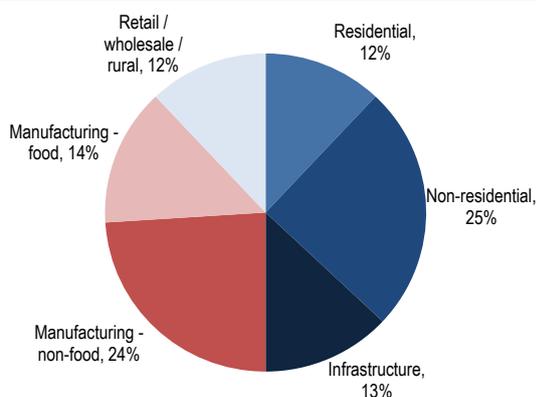
### Risks factors

- **Execution of turnaround initiatives.**
- **Competitive pressures on market share and margins.**
- **Domestic steel demand:** Demand for STU's products is impacted by cyclical construction, 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

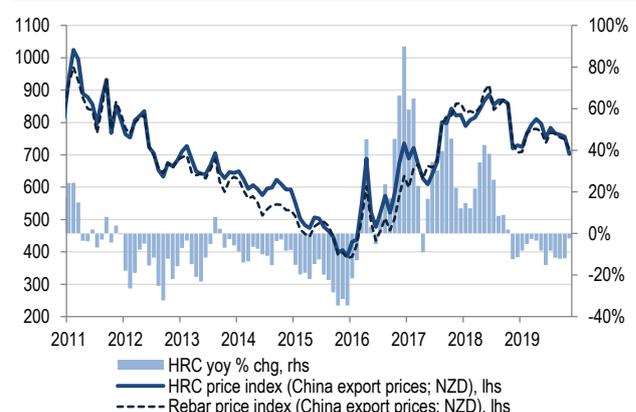
STU is NZ's largest steel distribution company with customers across the construction, manufacturing and rural sectors. It operates a nationwide network of >50 branches and distribution centres across its steel distribution, steel processing (eg. rollforming, reinforcing), stainless steel, fasteners 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 1. STU sector exposure (FY19)



Source: Company reports, Forsyth Barr analysis

Figure 2. Global steel prices



Source: Company reports, Forsyth Barr analysis

**Figure 3. Substantial Shareholders**

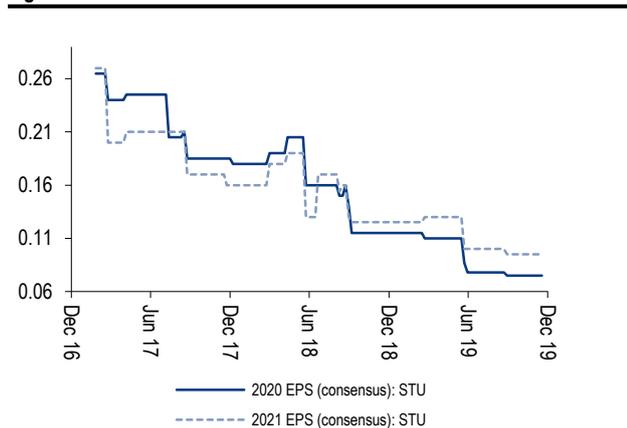
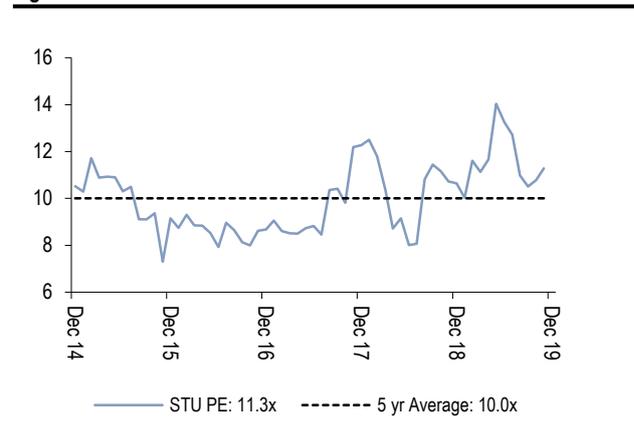
Shareholder	Latest Holding
New Zealand Steel Limited	15.8%

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

**Figure 4. International Compcos**

Company <i>(metrics re-weighted to reflect STU's balance date - June)</i>	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash D/Yld	
				2020E	2021E	2020E	2021E	2020E	2021E		
<b>Steel &amp; Tube Holdings</b>	<b>STU NZ</b>	<b>NZ\$0.79</b>	<b>NZ\$128</b>	<b>13.3x</b>	<b>9.3x</b>	<b>6.2x</b>	<b>5.3x</b>	<b>9.4x</b>	<b>7.4x</b>	<b>7.6%</b>	
Fletcher Building *	FBU NZ	NZ\$5.30	NZ\$4,432	15.0x	14.4x	6.8x	6.6x	9.4x	9.5x	4.5%	
Metro Performance Glass *	MPG NZ	NZ\$0.35	NZ\$65	4.3x	4.8x	3.8x	4.2x	5.8x	6.6x	11.6%	
Adelaide Brighton	ABC AT	A\$3.23	A\$2,105	17.2x	16.7x	10.0x	9.8x	15.0x	14.4x	4.0%	
Boral	BLD AT	A\$5.02	A\$5,885	14.6x	13.3x	7.7x	7.3x	13.5x	12.4x	4.7%	
BlueScope Steel	BSL AT	A\$14.39	A\$7,305	16.8x	12.4x	6.1x	5.2x	10.3x	8.1x	1.0%	
CSR	CSR AT	A\$4.64	A\$2,280	18.1x	17.0x	8.3x	8.3x	12.2x	12.2x	4.6%	
Wagners Holding Co	WGN AT	A\$2.00	A\$329	28.6x	18.5x	11.5x	8.8x	18.0x	12.5x	2.4%	
GWA Group	GWA AT	A\$3.19	A\$842	16.0x	15.3x	10.9x	10.6x	12.0x	11.6x	5.8%	
James Hardie Industries PLC	JHX AT	US\$19.61	US\$8,673	23.2x	20.7x	15.6x	14.2x	19.6x	17.8x	2.7%	
Reece	REH AT	A\$10.40	A\$5,833	23.0x	21.0x	13.4x	12.6x	17.2x	15.9x	2.2%	
Sims Metal Management	SGM AT	A\$10.81	A\$2,194	>50x	17.3x	11.0x	5.7x	67.0x	9.9x	2.7%	
<b>Compcpo Average:</b>				<b>17.7x</b>	<b>15.6x</b>	<b>9.6x</b>	<b>8.5x</b>	<b>18.2x</b>	<b>11.9x</b>	<b>4.2%</b>	
<i>EV = Current Market Cap + Actual Net Debt</i>				<b>STU Relative:</b>	<b>-24%</b>	<b>-40%</b>	<b>-35%</b>	<b>-37%</b>	<b>-48%</b>	<b>-38%</b>	<b>+81%</b>

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

**Figure 5. Consensus EPS Momentum**

**Figure 6. 12 Month Forward PE**


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