

# Steel & Tube Holdings

OUTPERFORM

## 1H Down the Tubes; Management Maintains Perennial Optimism

Steel & Tube (STU) has now quantified its previous guidance that 1H20 earnings will be down yoy, and the numbers are weak with EBIT down -70–80%. The period extends what has been a miserable run for STU shareholders. Despite the obvious challenges, we maintain our high risk OUTPERFORM view. In our opinion (and understandably) the market is pricing in a minimal earnings improvement from current levels. STU is highly levered to any benefits from self-help initiatives or easing in competitive pressures.

### What's changed?

- **Earnings:** Underlying EBIT FY20/21/22E -24%/-9%/-8%, with reported numbers more than offset by IFRS 16 adjustments.
- **Target Price:** Lowered to NZ95cps.

### Tough 1H20 confirmed

STU has advised it expects 1H EBIT of NZ\$2–3m, down -70–80% vs. 1H19 NZ\$9.4m before (1) the impact of IFRS 16 accounting changes, and (2) a non-cash goodwill impairment of c.NZ\$37m. Post-IFRS 16 this equates to EBIT of c.NZ\$5–6m.

STU believes it has “maintained market share and margins”, but has been impacted by (1) a c.-10% yoy decline in revenue on the back of “reduced vertical construction work and a contraction in the stainless steel market”, and (2) previously announced NZ\$2m of “Project Strive” costs (STU’s programme to improve customer service and operating efficiency) and NZ\$2m in bad debts.

The company does continue to reduce debt, down -NZ\$4m in the 1H to NZ\$11m, and it has sold a surplus property for NZ\$5.8m post period end.

### Material leverage to operational improvements and/or easing competition

STU management remains perennially optimistic. “An improved second half performance is expected as benefits from Project Strive, cost efficiencies, new project successes and other proactive measures take effect”. STU advised that further restructuring costs are possible.

Given STU’s poor track record of hitting targets, it is difficult to take confidence from management’s optimism. That said, we do see the medium-term risks as balanced — whilst STU is likely past peak cycle demand (1) we do not expect the downturn to be dramatic, (2) although infrastructure investment may soften near-term, government’s recent commitments underpin a healthy longer-term outlook, (3) bad debt costs should not reoccur to the same magnitude, (4) restructuring may deliver net cost savings, and (5) competition is negatively impacting all players across the industry and the pendulum of competitive intensity can swing. STU is highly levered to any improvement in costs, volumes, and/or margins.

### Investment View

We maintain 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\$0.82
Target price	NZ\$0.95
Risk rating	High
Issued shares	162.5m
Market cap	NZ\$133m
Avg daily turnover	159.3k (NZ\$162k)

### Share Price Performance



Financials: Jan/	19A	20E	21E	22E
NPAT* (NZ\$m)	10.0	5.2	11.6	12.2
EPS* (NZc)	6.5	3.2	7.2	7.5
EPS growth* (%)	-36.6	-50.9	n/a	4.5
DPS (NZc)	5.0	2.0	5.0	5.0
Imputation (%)	100	100	100	100

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	8.2	3.9	3.0	3.0
EV/EBIT	11.8	8.7	5.6	5.4
PE	12.6	25.6	11.5	11.0
Price / NTA	0.7	0.7	0.7	n/a
Cash div yld (%)	6.1	2.4	6.1	6.1
Gross div yld (%)	8.5	3.4	8.5	8.5

\*Historic/forecast numbers based on normalised profits

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

Priced as at 31 Jan 2020 (NZ\$)

**0.82**
**12-month target price (NZ\$)\***
**0.95**
**Spot valuations (NZ\$)**

Expected share price return	15.9%	1. DCF	0.90
Net dividend yield	4.9%	2. Sector peer relative	1.06
Estimated 12-month return	20.7%	3. Market relative	0.90

**Key WACC assumptions**

Risk free rate	2.00%
Equity beta	1.50
WACC	9.6%
Terminal growth	1.5%

**DCF valuation summary (NZ\$m)**

Total firm value	276
(Net debt)/cash	(15)
Less: Capitalised operating leases	(115)
Value of equity	146

**Profit and Loss Account (NZ\$m)**

	2018A	2019A	2020E	2021E	2022E
Sales revenue	496.8	499.1	463.8	474.2	484.3
<b>Normalised EBITDA</b>	<b>(9.5)</b>	<b>23.6</b>	<b>36.2</b>	<b>43.0</b>	<b>43.6</b>
Depreciation and amortisation	(8.1)	(7.3)	(20.1)	(19.7)	(19.5)
<b>Normalised EBIT</b>	<b>(17.5)</b>	<b>16.3</b>	<b>16.1</b>	<b>23.3</b>	<b>24.1</b>
Net interest	(4.6)	(2.8)	(8.8)	(7.2)	(7.2)
Associate income	-	-	-	-	-
Tax	8.8	(3.6)	(2.0)	(4.5)	(4.7)
Minority interests	-	-	-	-	-
<b>Normalised NPAT</b>	<b>9.0</b>	<b>10.0</b>	<b>5.2</b>	<b>11.6</b>	<b>12.2</b>
Abnormals/other	(18.7)	0.5	(37.0)	-	-
<b>Reported NPAT</b>	<b>(32.1)</b>	<b>10.4</b>	<b>(31.8)</b>	<b>11.6</b>	<b>12.2</b>
Normalised EPS (cps)	10.3	6.5	3.2	7.2	7.5
DPS (cps)	7.0	5.0	2.0	5.0	5.0

**Valuation Ratios**

	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	n/a	8.2	3.9	3.0	3.0
EV/EBIT (x)	n/a	11.8	8.7	5.6	5.4
PE (x)	8.0	12.6	25.6	11.5	11.0
Price/NTA (x)	0.6	0.7	0.7	0.7	0.7
Free cash flow yield (%)	-13.2	5.3	14.9	9.5	10.3
Net dividend yield (%)	8.5	6.1	2.4	6.1	6.1
Gross dividend yield (%)	11.2	8.5	3.4	8.5	8.5

**Growth Rates**

	2018A	2019A	2020A	2021A	2022A
Revenue (%)	-3.2	0.5	-7.1	2.2	2.1
EBITDA (%)	n/a	n/a	53.1	18.8	1.4
EBIT (%)	n/a	n/a	-1.7	45.3	3.1
Normalised NPAT (%)	-54.6	11.2	-47.8	>100	4.5
Normalised EPS (%)	-54.6	-36.6	-50.9	>100	4.5
Ordinary DPS (%)	-56.3	-28.6	-60.0	>100	0.0

**Key Ratios**

	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	-5.1	5.0	4.3	6.2	6.3
Return on equity (%)	5.2	3.9	2.6	5.6	5.7
Return on funds employed (%)	-4.0	4.1	3.9	7.3	7.5
EBITDA margin (%)	-1.9	4.7	7.8	9.1	9.0
EBIT margin (%)	-3.5	3.3	3.5	4.9	5.0
Capex to sales (%)	3.8	1.4	1.5	1.5	1.5
Capex to depreciation (%)	313	150	42	43	43
Imputation (%)	81	100	100	100	100
Pay-out ratio (%)	68	77	62	70	67

**Cash Flow (NZ\$m)**

	2018A	2019A	2020E	2021E	2022E
<b>EBITDA</b>	<b>(9.5)</b>	<b>23.6</b>	<b>36.2</b>	<b>43.0</b>	<b>43.6</b>
Working capital change	16.6	(0.2)	8.9	(4.0)	(3.2)
Interest & tax paid	1.5	(4.9)	(18.1)	(19.0)	(19.3)
Other	(7.3)	(4.4)	-	-	-
<b>Operating cash flow</b>	<b>1.3</b>	<b>14.1</b>	<b>27.0</b>	<b>20.0</b>	<b>21.1</b>
Capital expenditure	(19.0)	(7.0)	(7.1)	(7.3)	(7.4)
(Acquisitions)/divestments	52.8	2.3	5.8	-	-
Other	-	-	(11.6)	(11.7)	(11.8)
<b>Funding available/(required)</b>	<b>35.1</b>	<b>9.4</b>	<b>14.1</b>	<b>1.0</b>	<b>1.9</b>
Dividends paid	(12.7)	(5.9)	(4.1)	(4.9)	(8.1)
Equity raised/(returned)	0.0	78.8	-	-	-
<b>(Increase)/decrease in net debt</b>	<b>22.5</b>	<b>82.3</b>	<b>10.0</b>	<b>(3.9)</b>	<b>(6.3)</b>

**Operating Performance**

	2018A	2019A	2020E	2021E	2022E
<b>Operating revenue</b>	<b>495.8</b>	<b>498.1</b>	<b>462.8</b>	<b>473.2</b>	<b>483.2</b>
Cost of sales	398.4	387.1	358.7	366.8	374.5
<b>Gross margin</b>	<b>97.4</b>	<b>111.0</b>	<b>104.1</b>	<b>106.5</b>	<b>108.7</b>
Gross margin %	19.6%	22.3%	22.5%	22.5%	22.5%
Other revenue	1.0	1.0	1.0	1.0	1.0
<b>Expenses</b>					
Operating expenses	107.9	88.3	68.9	64.5	66.2
Depreciation and amortisation	8.1	7.3	20.1	19.7	19.5
<b>Total expenses</b>	<b>115.9</b>	<b>95.6</b>	<b>89.1</b>	<b>84.1</b>	<b>85.7</b>
<b>EBIT</b>	<b>(17.5)</b>	<b>16.3</b>	<b>16.1</b>	<b>23.3</b>	<b>24.1</b>
EBIT margin %	-3.5%	3.3%	3.5%	4.9%	5.0%
<b>Expenses % of sales</b>	<b>23.4%</b>	<b>19.2%</b>	<b>19.2%</b>	<b>17.8%</b>	<b>17.7%</b>

**Balance Sheet (NZ\$m)**

	2018A	2019A	2020E	2021E	2022E
Working capital	165.4	163.6	154.0	158.0	161.3
Fixed assets	52.7	52.0	48.9	51.7	54.4
Intangibles	57.4	56.9	16.9	14.3	12.2
Right of use asset	-	-	97.8	97.9	98.0
Other assets	14.6	3.5	3.5	3.5	3.5
<b>Total funds employed</b>	<b>290.1</b>	<b>276.1</b>	<b>321.1</b>	<b>325.5</b>	<b>329.4</b>
Net debt/(cash)	104.4	15.0	(2.2)	(5.7)	(6.8)
Lease liability	-	-	103.1	104.1	105.0
Other liabilities	13.1	7.2	18.1	18.1	18.2
Shareholder's funds	172.6	253.9	202.1	208.9	212.9
Minority interests	-	-	-	-	-
<b>Total funding sources</b>	<b>290.1</b>	<b>276.1</b>	<b>321.1</b>	<b>325.5</b>	<b>329.4</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\$30–35m 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.

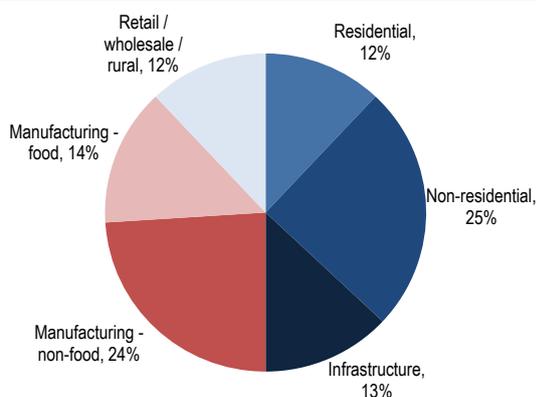
### Risks factors

- **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

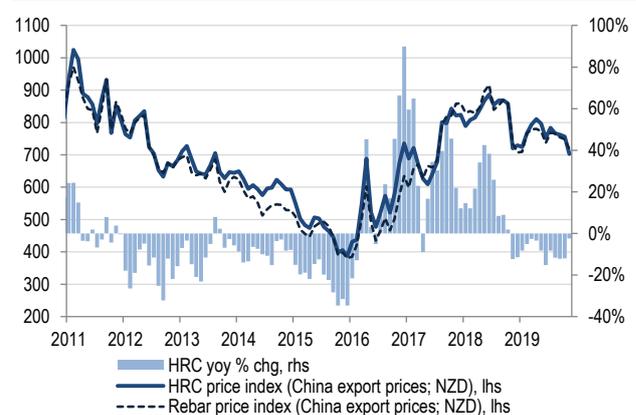
STU is NZ's largest steel distribution company with customers across the construction, manufacturing and rural sectors. It operates a nationwide network of >50 branches and distribution centres across its steel distribution, steel processing (eg. rollforming, reinforcing), stainless steel, fasteners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

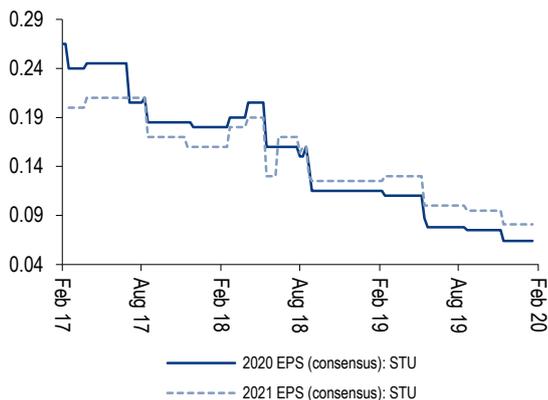
Figure 4. International Compcos

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
<i>(metrics re-weighted to reflect STU's balance date - June)</i>										
			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
<b>Steel &amp; Tube Holdings</b>	<b>STU NZ</b>	<b>NZ\$0.82</b>	<b>NZ\$133</b>	<b>25.6x</b>	<b>11.5x</b>	<b>4.1x</b>	<b>3.4x</b>	<b>9.2x</b>	<b>6.3x</b>	<b>6.1%</b>
Fletcher Building *	FBU NZ	NZ\$5.55	NZ\$4,581	16.3x	15.9x	7.1x	7.0x	10.0x	10.2x	4.1%
Metro Performance Glass *	MPG NZ	NZ\$0.26	NZ\$47	3.9x	3.5x	2.9x	3.1x	5.2x	5.2x	16.0%
Adelaide Brighton	ABC AT	A\$3.64	A\$2,372	19.4x	18.7x	10.9x	10.6x	16.6x	15.9x	3.7%
Boral	BLD AT	A\$4.98	A\$5,838	15.6x	13.8x	7.9x	7.4x	14.2x	12.8x	4.6%
BlueScope Steel	BSL AT	A\$14.25	A\$7,204	17.0x	12.1x	6.1x	5.0x	10.0x	7.3x	1.0%
CSR	CSR AT	A\$4.86	A\$2,388	19.2x	18.0x	8.7x	8.6x	12.9x	12.8x	4.3%
Wagners Holding Co	WGN AT	A\$2.14	A\$401	31.5x	17.7x	13.3x	9.6x	21.4x	13.6x	2.4%
GWA Group	GWA AT	A\$3.58	A\$945	18.2x	17.3x	12.1x	11.7x	13.3x	12.8x	5.0%
James Hardie Industries PLC	JHX AT	US\$21.00	US\$9,303	24.6x	21.8x	16.4x	15.1x	20.6x	18.7x	2.5%
Reece	REH AT	A\$11.13	A\$6,242	25.1x	22.9x	14.2x	13.3x	18.7x	17.1x	2.0%
Sims	SGM AT	A\$10.73	A\$2,173	>50x	18.7x	11.6x	6.0x	>75x	11.1x	2.5%
<b>Compcpo Average:</b>				<b>19.1x</b>	<b>16.4x</b>	<b>10.1x</b>	<b>8.9x</b>	<b>14.3x</b>	<b>12.5x</b>	<b>4.4%</b>
<b>STU Relative:</b>				<b>+34%</b>	<b>-30%</b>	<b>-60%</b>	<b>-61%</b>	<b>-35%</b>	<b>-49%</b>	<b>+39%</b>

EV = Current Market Cap + Actual Net Debt

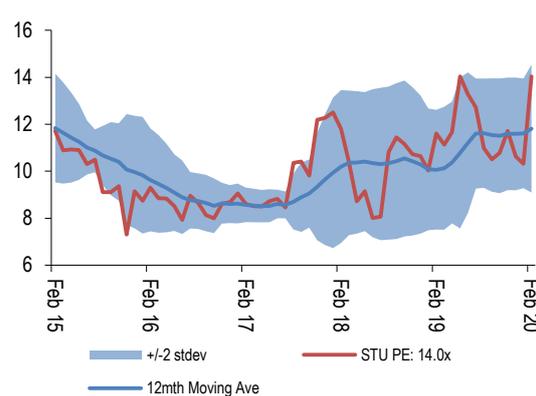
Source: \*Forsyth Barr analysis, Bloomberg Consensus, Compcpo metrics re-weighted to reflect headline (STU) companies fiscal year end

Figure 5. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 6. 12 Month Forward PE



Source: Forsyth Barr analysis

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