FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH | BUILDING | STEEL PRODUCER & DISTRIBUTER
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Steel & Tube Holdings
FY20 — Hatches Battened Down

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NEUTRAL

Steel & Tube's (STU) FY20 result was pre-released earlier this month. While NZ's lockdown makes it difficult to delineate operating trends STU appears to have performed no worse than peers and, consistent with industry anecdotes, post-lockdown trading has been solid. STU has battened down the hatches in preparation for likely difficult economic conditions ahead, reducing headcount, property footprint, working capital, and debt. We see the risk/reward as balanced and lower our rating to NEUTRAL with STU's depressed share price reflecting its significant operating leverage to the uncertain environment ahead.

NZX Code	STU
Share price	NZ$0.58
Target price	NZ$0.70
Risk rating	High
Issued shares	163.1m
Market cap	NZ$94.6m
Avg daily turnover	117.2k (NZ$83k)

Financials: Jun/	20A	21E	22E	23E
NPAT* (NZ$m)	-7.8	3.3	6.7	7.2
EPS* (NZc)	-4.8	2.0	4.1	4.4
EPS growth* (%)	n/a	n/a	n/a	6.8
DPS (NZc)	2.0	2.0	3.0	4.0
Imputation (%)	100	100	100	100
*Based on normalised profits				

Valuation (x)	20A	21E	22E	23E
EV/EBITDA	6.6	3.4	3.1	3.2
EV/EBIT	n/a	9.3	6.6	6.5
PE	n/a	28.5	14.0	13.1
Price / NTA	0.6	0.5	0.5	0.5
Cash div yld (%)	3.4	3.4	5.2	6.9
Gross div yld (%)	4.8	4.8	7.2	9.6

Cost base reset after 2H lockdown

Unsurprisingly, the lockdown significantly impacted STU's 2H20 with revenues down -18% yoy in its Distribution division and -28% in Infrastructure. This appears no worse than Fletcher Steel with volumes down -16%, and NZ Steel with long steel products -25% and flat products -16%. In line with industry anecdotes, STU highlighted better-than-expected post lockdown trading with June and July down low single digits vs. the pcp.

Given the highly uncertain outlook STU has materially restructured its cost base. Headcount and operating sites have reduced c.20% vs. pre COVID-19 levels to 830 and 25 respectively, underpinning annual cost savings of NZ$12–13m (with c.NZ$10m being realised in FY21). Strong working capital management positioned STU with NZ$7m net cash at year end.

Unsurprisingly, no FY21 guidance has been provided. Management highlighted likely softness in its key non-residential market with better outlooks in residential and infrastructure (supported by government stimulus, but with uncertain timing). We have lowered our FY21–23 NPAT forecasts -63%/-15%/-7% and highlight the very high margin of error in any STU earnings forecast at this point in time.

Abundant uncertainty, downgrade to NEUTRAL

We lower our rating to NEUTRAL. Despite the stock price at a >25-year low we believe the risk/reward is broadly balanced given STU's substantial operating leverage to the highly uncertain outlook. While near-term trading is solid we expect demand to fade over the year as economic activity declines. Competition is negatively impacting all players across the industry and is unlikely to diminish near-term as volumes decline. Partially offsetting this, STU's 1H bad debt costs should not reoccur to the same magnitude, and its restructuring initiatives will likely deliver net cost savings. Longer-term the pendulum of competitive intensity may swing in STU's favour if the industry becomes more rational.

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Steel & Tube Holdings Limited (STU)

Priced as at 28 Aug 2020 (NZ$)	**0.58**

12-month target price (NZ$)*	**0.70**
Expected share price return	20.7%
Net dividend yield	3.7%
Estimated 12-month return	24.4%

Key WACC assumptions	
Risk free rate	1.30%
Equity beta	1.50
WACC	7.9%
Terminal growth	1.5%

Profit and Loss Account (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Sales revenue	499.1	425.4	433.2	420.5	425.2
Normalised EBITDA	**23.6**	**15.0**	**26.7**	**30.0**	**29.3**
Depreciation and amortisation	(7.3)	(20.5)	(16.9)	(15.9)	(15.0)
Normalised EBIT	**16.3**	**(5.5)**	**9.7**	**14.1**	**14.3**
Net interest	(2.8)	(6.7)	(5.1)	(4.7)	(4.3)
Associate income	0	0	0	0	0
Tax	(3.6)	4.3	(1.3)	(2.6)	(2.8)
Minority interests	0	0	0	0	0
Normalised NPAT	**10.0**	**(7.8)**	**3.3**	**6.7**	**7.2**
Abnormals/other	0.5	(52.2)	0	0	0
Reported NPAT	**10.4**	**(60.0)**	**3.3**	**6.7**	**7.2**
Normalised EPS (cps)	6.5	(4.8)	2.0	4.1	4.4
DPS (cps)	5.0	2.0	2.0	3.0	4.0

Growth Rates	**2019A**	**2020A**	**2021A**	**2022A**	**2023A**
Revenue (%)	0.5	-14.8	1.8	-2.9	1.1
EBITDA (%)	n/a	-36.7	78.1	12.4	-2.2
EBIT (%)	n/a	n/a	n/a	44.7	1.4
Normalised NPAT (%)	11.2	n/a	n/a	>100	6.8
Normalised EPS (%)	-36.7	n/a	n/a	>100	6.8
Ordinary DPS (%)	-28.6	-60.0	0.0	50.0	33.3

Cash Flow (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
EBITDA	**23.6**	**15.0**	**26.7**	**30.0**	**29.3**
Working capital change	(0.2)	31.5	(7.3)	3.5	(1.4)
Interest & tax paid	(4.9)	(7.9)	(11.7)	(12.2)	(11.5)
Other	(4.4)	(5.2)	0	0	0
Operating cash flow	**14.1**	**33.3**	**7.7**	**21.3**	**16.4**
Capital expenditure	(7.0)	(7.1)	(7.3)	(7.4)	(7.6)
(Acquisitions)/divestments	2.3	5.9	1.3	0	0
Other	0	(13.0)	(11.8)	(10.8)	(9.8)
Funding available/(required)	**9.4**	**19.1**	**(10.0)**	**3.1**	**(1.0)**
Dividends paid	(5.9)	(2.5)	(1.6)	(4.9)	(4.9)
Equity raised/(returned)	78.8	0	0	0	0
(Increase)/decrease in net debt	**82.3**	**16.6**	**(11.7)**	**(1.8)**	**(5.9)**

Balance Sheet (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Working capital	163.6	135.8	143.1	139.4	140.8
Fixed assets	52.0	41.0	42.8	45.7	48.5
Intangibles	56.9	11.9	10.5	9.3	8.3
Right of use asset	0	87.1	78.4	70.6	63.6
Other assets	3.5	14.0	13.6	13.6	13.6
Total funds employed	**276.1**	**289.7**	**288.4**	**278.6**	**274.7**
Net debt/(cash)	15.0	(7.4)	(1.0)	(4.1)	(2.6)
Lease liability	0	95.1	85.9	77.6	69.8
Other liabilities	7.2	20.8	20.5	20.2	20.3
Shareholder's funds	253.9	181.3	183.0	184.8	187.1
Minority interests	0	0	0	0	0
Total funding sources	**276.1**	**289.7**	**288.4**	**278.6**	**274.7**

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

Spot valuations (NZ$)	
1. DCF	0.59
2. Sector peer relative	0.53
3. Market relative	0.97

DCF valuation summary (NZ$m)	
Total firm value	283
(Net debt)/cash	7
Less: Capitalised operating leases	(194)
Value of equity	96

Valuation Ratios	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
EV/EBITDA (x)	6.5	6.6	3.4	3.1	3.2
EV/EBIT (x)	9.4	n/a	9.3	6.6	6.5
PE (x)	8.9	n/a	28.5	14.0	13.1
Price/NTA (x)	0.5	0.6	0.5	0.5	0.5
Free cash flow yield (%)	7.5	27.7	0.5	14.7	9.3
Net dividend yield (%)	8.6	3.4	3.4	5.2	6.9
Gross dividend yield (%)	12.0	4.8	4.8	7.2	9.6

Capital Structure	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Interest cover EBIT (x)	5.8	n/a	1.9	3.0	3.3
Interest cover EBITDA (x)	8.4	2.2	5.2	6.3	6.8
Net debt/ND+E (%)	5.6	-4.3	-0.6	-2.2	-1.4
Net debt/EBITDA (x)	0.6	n/a	n/a	n/a	n/a

Key Ratios	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Return on assets (%)	5.0	-1.6	2.8	4.2	4.3
Return on equity (%)	3.9	-4.3	1.8	3.6	3.8
Return on funds employed (%)	4.1	-2.7	3.1	4.9	5.0
EBITDA margin (%)	4.7	3.5	6.2	7.1	6.9
EBIT margin (%)	3.3	-1.3	2.3	3.4	3.4
Capex to sales (%)	1.4	1.7	1.7	1.8	1.8
Capex to depreciation (%)	150	40	47	51	54
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	77	-42	98	73	91

Operating Performance	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Operating revenue	**498.1**	**417.9**	**431.4**	**418.7**	**423.4**
Cost of sales	387.1	333.8	340.8	326.6	330.2
Gross margin	**111.0**	**84.1**	**90.6**	**92.1**	**93.1**
Gross margin %	22.3%	20.1%	21.0%	22.0%	22.0%
Other revenue	1.0	7.4	1.8	1.8	1.9
Expenses					
Operating expenses	88.3	76.6	65.7	64.0	65.7
Depreciation and amortisation	7.3	20.5	16.9	15.9	15.0
Total expenses	**95.6**	**97.1**	**82.6**	**79.8**	**80.7**
EBIT	**16.3**	**(5.5)**	**9.7**	**14.1**	**14.3**
EBIT margin %	3.3%	-1.3%	2.3%	3.4%	3.4%
Expenses % of sales	**19.2%**	**23.2%**	**19.2%**	**19.1%**	**19.1%**

Figure 1. Earnings revisions

NZ$m		FY21E			FY22E			FY23E	
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Revenue	451.7	433.2	-4.1%	448.2	420.5	-6.2%	452.7	425.2	-6.1%
EBIT	18.0	9.7	-45.7%	16.6	14.1	-15.1%	16.4	14.3	-12.8%
Adjusted NPAT	8.9	3.3	-62.7%	7.9	6.7	-14.7%	7.8	7.2	-7.4%
Adjusted EPS (cps)	5.5	2.0	-62.8%	4.9	4.1	-15.0%	4.8	4.4	-7.7%
Dividend (cps)	4.0	2.0	-50.0%	4.0	3.0	-25.0%	4.0	4.0	0.0%

Source: Forsyth Barr analysis

Investment Summary

We rate Steel & Tube (STU) as NEUTRAL. Although the stock price at a >25-year low, in our view, the risk/reward is balanced with STU's depressed share price reflecting of its significant operating leverage to the uncertain environment ahead.

Business quality

- **Intense industry competition:** STU operates in a fragmented and highly competitive industry. Over an extended period STU has shed material market share in its core distribution business principally. This may have been checked more recently, but potentially 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 cashflow outlook

- **COVID-19 adds to difficult turnaround:** STU's board and management were pursuing a change programme focussed on improved customer service and efficiency, with ambitious medium-term earnings growth targets. COVID-19 and its likely impact on demand compounds the challenges of delivering on these objectives. The number and magnitude of profit warnings in recent years emphasises that management's optimism be approached with a high degree of caution.

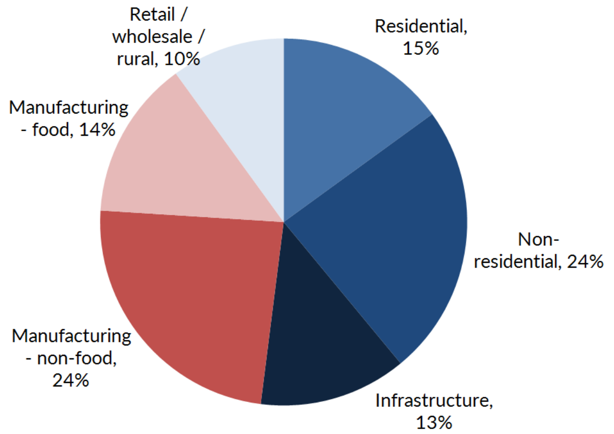
Financial structure

- **Strong 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 NZ$7m net cash as at FY20 year end. Underlying gearing remains full given its considerable off balance sheet debt. Capitalising operating leases at 6% FY20E net debt/EBITDA remains at an elevated 8.3x.

Risk factors

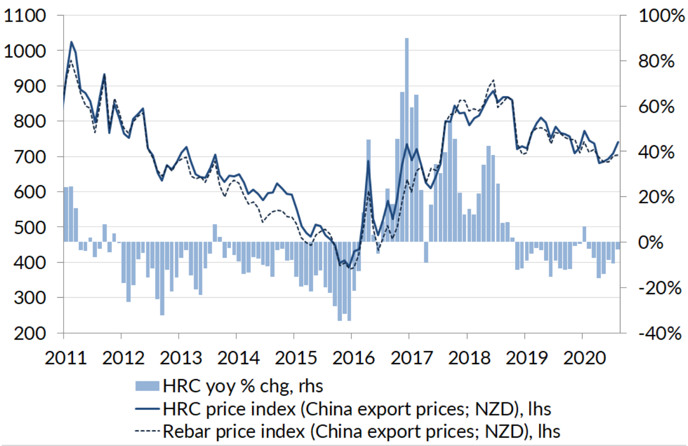
- **Execution of cost savings and turnaround initiatives.**
- **Competitive pressures on market share and margins.**
- **Domestic steel demand:** Demand for STU's products is impacted by cyclical construction, manufacturing activity, and volatile commodity prices.
- **Steel prices:** Global steel prices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

Figure 2. STU revenue exposure (FY20)



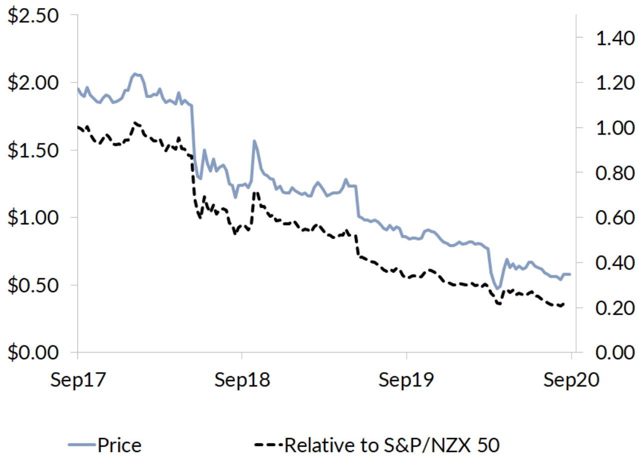
Source: Company reports, Forsyth Barr analysis

Figure 3. Global steel prices



Source: Bloomberg, Forsyth Barr analysis

Figure 4. Price performance



Source: Forsyth Barr analysis

Figure 5. Substantial shareholders

Shareholder	Latest Holding
New Zealand Steel Limited	15.8%

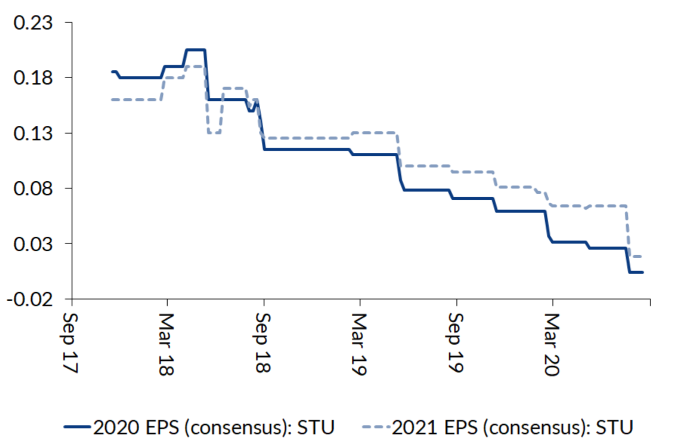
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 6. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect STU's balance date - June)			(m)	2021E	2022E	2021E	2022E	2021E	2022E	2022E
Steel & Tube Holdings	**STU NZ**	**NZ$0.58**	**NZ$95**	**28.5x**	**14.0x**	**3.3x**	**2.9x**	**8.9x**	**6.2x**	**5.2%**
FLETCHER BUILDING *	FBU NZ	NZ$3.51	NZ$2,893	11.8x	15.1x	4.5x	4.8x	8.2x	9.2x	4.8%
METRO PERFORMANCE GLASS	MPG NZ	NZ$0.24	NZ$44	16.2x	24.0x	5.6x	6.2x	15.7x	18.6x	0.5%
ADBRI	ABC AT	A$2.48	A$1,614	16.7x	16.7x	8.6x	8.4x	14.3x	14.3x	4.7%
BORAL	BLD AT	A$3.92	A$4,798	27.6x	16.6x	8.6x	7.3x	22.2x	15.4x	3.7%
BLUESCOPE STEEL	BSL AT	A$12.63	A$6,348	24.4x	13.6x	6.6x	4.8x	14.7x	8.6x	1.1%
CSR	CSR AT	A$3.59	A$1,743	15.1x	16.1x	6.6x	6.8x	10.2x	10.8x	4.1%
WAGNERS HOLDING CO	WGN AT	A$1.18	A$221	n/a	20.7x	11.3x	9.9x	22.5x	17.9x	2.4%
GWA GROUP	GWA AT	A$2.54	A$669	16.6x	15.0x	11.0x	9.9x	14.2x	12.4x	5.4%
JAMES HARDIE INDUSTRIES-CDI	JHX AT	US$23.36	US$10,352	26.4x	23.0x	16.7x	15.0x	21.0x	18.8x	2.3%
REECE	REH AT	A$12.40	A$8,010	30.9x	29.2x	14.3x	14.0x	23.9x	20.3x	1.5%
SIMS	SGM AT	A$8.04	A$1,618	46.2x	16.0x	7.1x	5.3x	32.4x	12.6x	2.8%
			Compco Average:	**23.2x**	**18.7x**	**9.2x**	**8.4x**	**18.1x**	**14.4x**	**3.0%**
EV = Current Market Cap + Actual Net Debt			**STU Relative:**	**23%**	**-25%**	**-64%**	**-65%**	**-51%**	**-57%**	**71%**

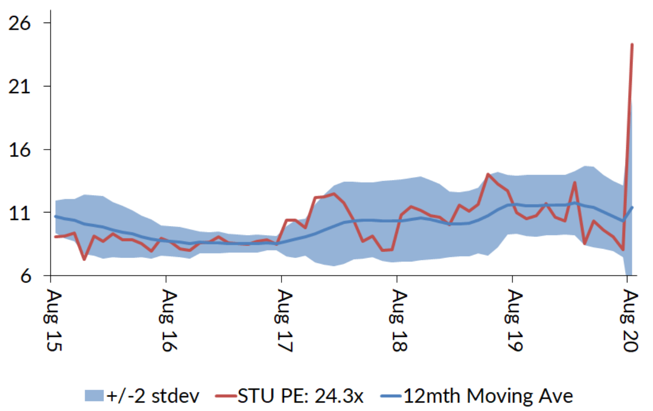
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (STU) companies fiscal year end

Figure 7. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 8. One year forward PE (x)



Source: Forsyth Barr analysis

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