

# Fletcher Building

## FY20 Pre-announced — Some More One-Offs

**ROHAN KOREMAN-SMIT CFA**

rohan.koreman-smit@forsythbarr.co.nz  
+64 9 368 0085

**ASHTON OLDS**

ashton.olds@forsythbarr.co.nz  
+64 9 368 0127

### NEUTRAL

Fletcher Building (FBU) has pre-announced its FY20 result, with underlying EBIT of NZ\$310m, and one-off adjustments leading to a net loss of NZ\$196m. This is a slight improvement on FBU's May update, however, given the consistent anecdotes of strong post-lockdown construction activity we suspected it might have been higher. We anticipate activity and FBU's revenue will remain solid near-term but fade as current projects are completed and the pipeline empties through CY21. The risk is this downturn is not only cyclical but leads to a further erosion in the business's underlying quality. Whilst FBU's share price remains down sharply from pre COVID-19 levels, it's not at a level where we see clear value. FBU will report its FY20 result in full on 19 August 2020. We lower our target price -10cps to NZ\$3.70 and maintain our NEUTRAL rating.

NZX Code	FBU	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$3.50	NPAT* (NZ\$m)	367.0	60.1	233.5	179.7	EV/EBITDA	4.3	6.3	4.3	4.4
Target price	NZ\$3.70	EPS* (NZc)	43.1	7.2	28.4	21.9	EV/EBIT	5.6	20.0	8.0	8.9
Risk rating	Medium	EPS growth* (%)	n/a	-83.2	n/a	-23.0	PE	8.1	48.4	12.3	16.0
Issued shares	821.7m	DPS (NZc)	23.0	0.0	17.0	16.0	Price / NTA	1.0	1.3	1.2	1.2
Market cap	NZ\$2,876m	Imputation (%)	0	n/a	65	69	Cash div yld (%)	6.6	0.0	4.9	4.6
Avg daily turnover	1,903k (NZ\$8,022k)	*Based on normalised profits					Gross div yld (%)	6.6	n/a	6.1	5.8

### Robust post lockdown activity in NZ but not consistent across divisions

FBU has pre announced its FY20 result with underlying EBIT of NZ\$310m but an NPAT loss of NZ\$196m due to further construction provisions of NZ\$150m and impairments of NZ\$276m. This is a slight improvement on FBU's May update which implied FY20 underlying EBIT of c.NZ\$275-300m (cf. 1H20 NZ\$219m/FY19 NZ\$549m excl. Formica). We expect NZ residential focussed divisions have likely performed well post lockdown but anticipate an impact on (1) Residential, given the inability to sell over key April/ May months (and therefore settle before FY20 year end), (2) Steel, given competitive pressures, and (3) Australia, which was in the middle of executing turnaround initiatives when the pandemic struck.

### Right sizing for a sharp downturn ahead

FBU has reset its cost base through workforce reduction, ceasing unproductive product lines, and the closure of facilities and offices. FBU expects that this will lead to c.NZ\$300m of annual cost savings, beginning in FY21. FBU believes this cost-out positions the business for a 25% decline in NZ activity and 20% in Australia. Our modelling assumes costs reduce with volumes, however, we are not confident we'll see net benefits to shareholders. Historically, extensive cost savings initiatives have been more than offset by competition and cost pressures.

### Risk remains that COVID causes further underlying deterioration in FBU's business

There remains risk both around the magnitude of the downturn, and more significantly, of further underlying deterioration in FBU's businesses. Competition may continue (or compound) margin pressures. Falling demand exacerbates the challenges of executing on turnaround initiatives. And a pullback in capex may starve the business of necessary investment. Our concern is FBU may emerge from the downturn weaker than when it went in.

## Fletcher Building (FBU)

Priced as at 11 Aug 2020 (NZ\$) **3.50**

<b>12-month target price (NZ\$)*</b>	<b>3.70</b>
Expected share price return	5.7%
Net dividend yield	4.8%
Estimated 12-month return	10.5%

### Key WACC assumptions

Risk free rate	1.30%
Equity beta	1.31
WACC	7.5%
Terminal growth	2.0%

### Spot valuations (NZ\$)

1. DCF	3.59
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### DCF valuation summary (NZ\$m)

Total firm value	6,383
(Net debt)/cash	(325)
Less: Capitalised operating leases	(3,106)
Value of equity	2,952

Profit and Loss Account (NZ\$m)	2018A	2019A	2020E	2021E	2022E
Sales revenue	9,471.0	9,307.0	7,143.3	7,449.0	7,369.1
<b>Normalised EBITDA</b>	<b>264.0</b>	<b>830.0</b>	<b>513.6</b>	<b>786.1</b>	<b>761.7</b>
Depreciation and amortisation	(214.0)	(199.0)	(353.0)	(366.9)	(386.7)
<b>Normalised EBIT</b>	<b>50.0</b>	<b>631.0</b>	<b>160.7</b>	<b>419.2</b>	<b>375.1</b>
Net interest	(157.0)	(118.0)	(142.3)	(111.9)	(111.8)
Associate income	0	0	0	0	0
Tax	58.0	(133.0)	52.1	(60.8)	(73.7)
Minority interests	11.0	13.0	10.4	12.9	9.9
<b>Normalised NPAT</b>	<b>(60.0)</b>	<b>367.0</b>	<b>60.1</b>	<b>233.5</b>	<b>179.7</b>
Abnormals/other	(130.0)	(203.0)	(266.0)	(90.0)	0
<b>Reported NPAT</b>	<b>(190.0)</b>	<b>164.0</b>	<b>(205.9)</b>	<b>143.5</b>	<b>179.7</b>
Normalised EPS (cps)	(8.3)	43.1	7.2	28.4	21.9
DPS (cps)	0	23.0	0	17.0	16.0

Growth Rates	2018A	2019A	2020E	2021E	2022E
Revenue (%)	0.8	-1.7	-23.2	4.3	-1.1
EBITDA (%)	-63.7	>100	-38.1	53.0	-3.1
EBIT (%)	-90.5	>100	-74.5	>100	-10.5
Normalised NPAT (%)	n/a	n/a	-83.6	>100	-23.0
Normalised EPS (%)	n/a	n/a	-83.2	>100	-23.0
Ordinary DPS (%)	-100.0	n/a	-100.0	n/a	-5.9

Cash Flow (NZ\$m)	2018A	2019A	2020E	2021E	2022E
<b>EBITDA</b>	<b>264.0</b>	<b>830.0</b>	<b>513.6</b>	<b>786.1</b>	<b>761.7</b>
Working capital change	430.0	(404.0)	111.2	(163.1)	(104.6)
Interest & tax paid	(243.0)	(156.0)	(212.1)	(182.5)	(183.2)
Other	(55.0)	(117.0)	(60.0)	(142.0)	0
<b>Operating cash flow</b>	<b>396.0</b>	<b>153.0</b>	<b>352.8</b>	<b>298.4</b>	<b>473.9</b>
Capital expenditure	(304.0)	(348.0)	(232.0)	(225.0)	(300.0)
(Acquisitions)/divestments	76.0	1,262.0	0	0	0
Other	0	0	(164.7)	(166.7)	(168.6)
<b>Funding available/(required)</b>	<b>168.0</b>	<b>1,067.0</b>	<b>(44.0)</b>	<b>(93.3)</b>	<b>5.4</b>
Dividends paid	(123.0)	(68.0)	(127.6)	(49.3)	(131.5)
Equity raised/(returned)	893.0	(81.0)	(147.0)	0	0
<b>(Increase)/decrease in net debt</b>	<b>938.0</b>	<b>918.0</b>	<b>(318.6)</b>	<b>(142.6)</b>	<b>(126.1)</b>

Balance Sheet (NZ\$m)	2018A	2019A	2020E	2021E	2022E
Working capital	1,641.0	1,384.0	1,234.8	1,227.0	1,206.6
Fixed assets	2,231.0	1,754.0	1,602.2	1,697.7	1,796.8
Intangibles	1,696.0	1,129.0	1,129.0	1,129.0	1,129.0
Right of use asset	0	0	1,502.4	1,504.7	1,507.1
Other assets	765.0	817.0	879.1	818.3	744.6
<b>Total funds employed</b>	<b>6,333.0</b>	<b>5,084.0</b>	<b>6,347.5</b>	<b>6,376.7</b>	<b>6,384.0</b>
Net debt/(cash)	1,273.0	325.0	597.2	675.0	740.1
Lease liability	0	0	1,822.8	1,843.8	1,863.3
Other liabilities	918.0	586.0	548.0	377.0	252.0
Shareholder's funds	4,118.0	4,141.0	3,347.5	3,448.9	3,496.6
Minority interests	24.0	32.0	32.0	32.0	32.0
<b>Total funding sources</b>	<b>6,333.0</b>	<b>5,084.0</b>	<b>6,347.5</b>	<b>6,376.7</b>	<b>6,384.0</b>

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

Valuation Ratios	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	16.4	4.3	6.3	4.3	4.4
EV/EBIT (x)	86.6	5.6	20.0	8.0	8.9
PE (x)	n/a	8.1	48.4	12.3	16.0
Price/NTA (x)	1.2	1.0	1.3	1.2	1.2
Free cash flow yield (%)	3.2	-6.8	4.2	2.6	6.0
Net dividend yield (%)	0.0	6.6	0.0	4.9	4.6
Gross dividend yield (%)	0.0	6.6	n/a	6.1	5.8

Capital Structure	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	0.3	5.3	1.1	3.7	3.4
Interest cover EBITDA (x)	1.7	7.0	3.6	7.0	6.8
Net debt/ND+E (%)	23.6	7.3	15.1	16.4	17.5
Net debt/EBITDA (x)	4.8	0.4	1.2	0.9	1.0

Key Ratios	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	0.6	8.2	1.9	4.9	4.4
Return on equity (%)	-1.5	8.9	1.8	6.8	5.1
Return on funds employed (%)	-1.1	8.8	24.1	7.7	5.7
EBITDA margin (%)	2.8	8.9	7.2	10.6	10.3
EBIT margin (%)	0.5	6.8	2.2	5.6	5.1
Capex to sales (%)	3.2	3.7	3.2	3.0	4.1
Capex to depreciation (%)	142	175	66	61	78
Imputation (%)	100	0	n/a	65	69
Pay-out ratio (%)	0	53	0	60	73

Operating Performance	2018A	2019A	2020E	2021E	2022E
<b>External revenue (NZ\$m)</b>					
New Zealand	5,063	5,220	4,371	4,812	4,677
Australia	3,018	2,944	2,618	2,481	2,533
Rest of World	1,390	1,143	154	156	159
<b>Total external revenue</b>	<b>9,471</b>	<b>9,307</b>	<b>7,143</b>	<b>7,449</b>	<b>7,369</b>

EBIT (NZ\$m)	2018A	2019A	2020E	2021E	2022E
Concrete	90	84	61	82	68
Building Products	132	127	95	116	102
Distribution	104	104	80	99	75
Steel	49	33	(7)	11	11
Construction	(608)	47	(123)	43	52
Residential / Land Developm't	136	137	65	102	88
Australia	114	57	25	22	35
Divested	78	82	0	0	0
Corporate / other	(45)	(40)	(35)	(55)	(56)
<b>Total EBIT</b>	<b>50</b>	<b>631</b>	<b>161</b>	<b>419</b>	<b>375</b>

EBIT (NZ\$m)	2018A	2019A	2020E	2021E	2022E
New Zealand	(180)	467	126	388	326
Australia	123	54	18	14	27
Rest of World	107	110	17	17	22
<b>Total EBIT</b>	<b>50</b>	<b>631</b>	<b>161</b>	<b>419</b>	<b>375</b>

## Investment Summary

Unfortunately, Fletcher Building (FBU) did not enter the COVID-19 crisis in fighting shape. NZ margins have long been under pressure. Australian turnaround efforts have delivered little tangible reward. Necessary reinvestment has elevated capex. The risk is this downturn is not only cyclical, but leads to a further erosion in the business's underlying quality. Whilst FBU's share price remains down sharply from pre COVID-19 levels, it's not at a level where we see clear value. NEUTRAL.

### Business quality

- **Competition pressuring NZ franchises:** Whilst FBU's NZ businesses typically maintain leading market positions, over the past decade the strength of these positions has generally deteriorated with increased domestic and import competition pressuring margins and market share (a trend we expect will continue).
- **Low quality Australian portfolio:** FBU's poor performing Australian businesses currently earn a c.1–2% EBIT return on the c.NZ\$3b acquisition cost. FBU is aiming to 4x its Australian EBIT (vs. FY19) over the next five years through improved margins and new investment. We are sceptical given competitive constraints and high operating leverage to slowing demand.

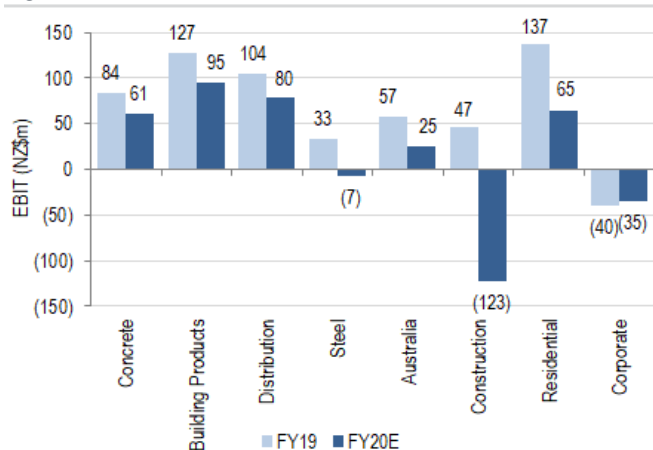
### Earnings and cashflow outlook

- **Limited medium-term free cash flow:** Reflecting crystallisation of construction losses and capex materially ahead of depreciation.
- **Strong balance sheet and capital management:** Proceeds from the sale of Formica have lowered FBU's net debt to c.1.0x even on our COVID-19 impacted earnings forecasts, below its 1.5–2.5x EBITDA target.

### Risk factors

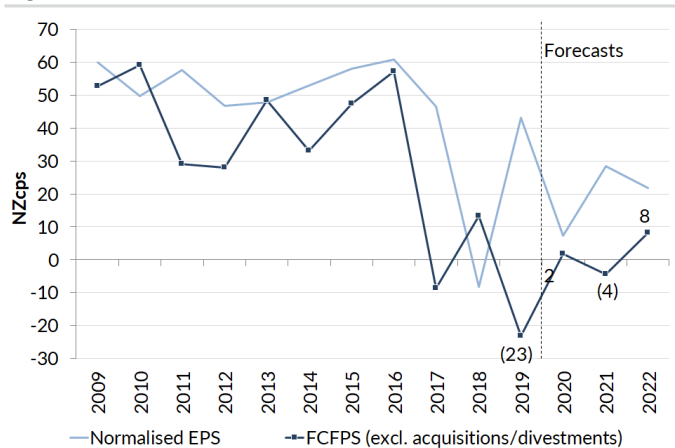
- **COVID-19:** Represents a massive near-term uncertainty for most businesses. We anticipate construction activity will bounce back once lockdown restrictions are fully lifted, but fade as current projects are completed and the pipeline empties.
- **Construction cycles in NZ and Australia:** FBU is levered to cyclical construction activity in NZ and AU, weighted to residential in both markets.
- **Competitive pressures:** Competition and cost inflation could materially influence FBU's market share and margins.
- **Construction losses:** Consensus view is that company has likely "kitchen sinked" its loss provisions, but the risk will not be extinguished until the projects are complete. Anecdotes of staff losses and project issues persist.

Figure 1. Divisional EBIT

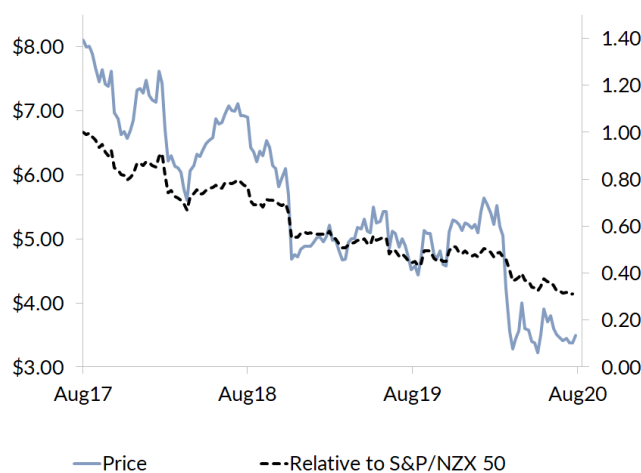


Source: Company reports, Forsyth Barr analysis

Figure 2. EPS and FCFPS



Source: Company reports, Forsyth Barr analysis

**Figure 3. Price performance**


Source: Forsyth Barr analysis

**Figure 4. Substantial shareholders**

Shareholder	Latest Holding
Perpetual	8.9%
Schroder Investment Management Group	8.3%
Commonwealth Bank of Australia	6.0%
The Vanguard Group	5.6%
Allan Gray Group	5.1%

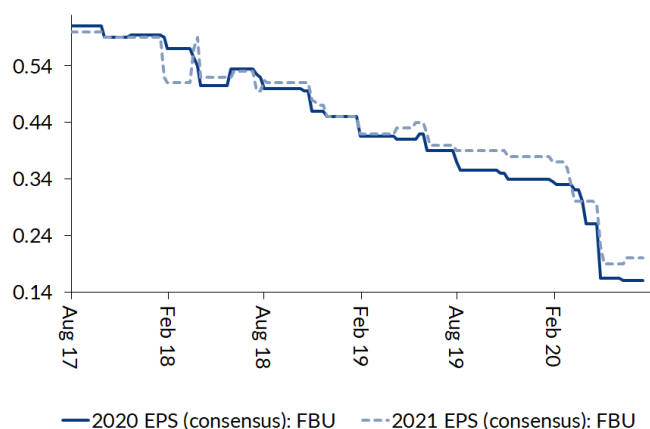
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

**Figure 5. International valuation comparisons**

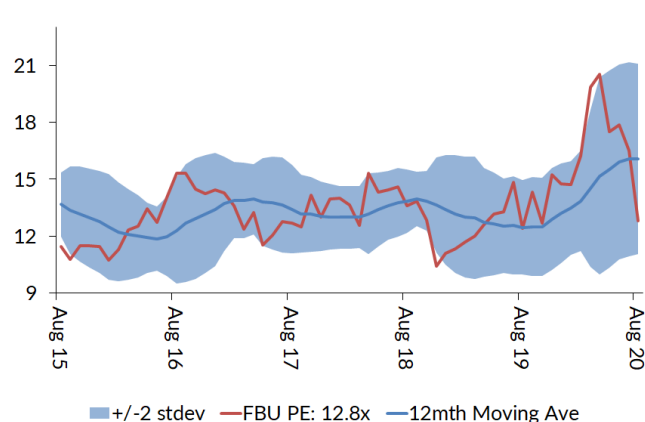
Company	Code	Price	Mkt Cap (m)	PE 2020E	PE 2021E	EV/EBITDA 2020E	EV/EBITDA 2021E	EV/EBIT 2020E	EV/EBIT 2021E	Cash Yld 2021E
(metrics re-weighted to reflect FBU's balance date - June)										
Fletcher Building	FBU NZ	NZ\$3.50	NZ\$2,876	48.4x	12.3x	6.2x	4.1x	19.9x	7.6x	4.9%
METRO PERFORMANCE GLASS	MPG NZ	NZ\$0.20	NZ\$37	2.1x	13.8x	4.0x	5.4x	8.7x	15.1x	0.0%
STEEL & TUBE HOLDINGS *	STU NZ	NZ\$0.58	NZ\$96	22.2x	8.4x	3.2x	2.7x	7.9x	5.2x	10.3%
ADBRI	ABC AT	A\$2.30	A\$1,500	23.5x	15.9x	8.5x	8.3x	26.6x	13.7x	4.1%
BORAL	BLD AT	A\$3.75	A\$4,596	23.7x	26.2x	8.7x	8.9x	21.0x	23.0x	2.3%
CSR	CSR AT	A\$3.60	A\$1,747	14.2x	15.2x	5.8x	6.6x	9.5x	10.2x	3.6%
WAGNERS HOLDING CO	WGN AT	A\$0.97	A\$181	>50x	24.1x	14.0x	9.4x	35.8x	18.6x	1.2%
GWA GROUP	GWA AT	A\$2.72	A\$718	14.9x	15.2x	10.1x	10.5x	12.2x	13.2x	4.7%
JAMES HARDIE INDUSTRIES-CDI	JHX AT	US\$21.70	US\$9,616	36.6x	27.1x	20.9x	16.8x	29.5x	21.7x	1.0%
REECE	REH AT	A\$10.49	A\$6,776	26.9x	27.8x	14.5x	14.3x	21.9x	23.5x	1.1%
CRH PLC	CRH ID	€33.11	€25,989	17.2x	18.7x	8.8x	9.0x	14.9x	15.4x	2.6%
LAFARGEHOLCIM-REG	LHN SW	CHF43.91	CHF27,045	14.2x	15.2x	6.7x	6.7x	11.9x	11.5x	4.6%
Compco Average:				19.6x	18.9x	9.6x	9.0x	18.2x	15.5x	3.2%
FBU Relative:				147%	-35%	-35%	-55%	10%	-51%	50%

EV = Current Market Cap + Actual Net Debt

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

**Figure 6. Consensus EPS momentum (NZ\$)**


Source: Forsyth Barr analysis

**Figure 7. One year forward PE (x)**


Source: Forsyth Barr analysis

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