PROGRESSIVE
EQUITY RESEARCH

20 May 2019

FORTERRA
BUILDING MATERIALS

FORT.L

288p

Market Cap: £576.7m

SHARE PRICE (p)

12m high/low	333p/209p

Source: LSE Data

KEY INFORMATION

Enterprise value	£615.5m
Index/market	LSE
Next news	Interims, 30 July 2019
Gearing	6.7%
Interest cover	29.2x

FORTERRA IS A RESEARCH CLIENT OF PROGRESSIVE

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Focus on cashflow pays dividends

Leading brickmaker Forterra has increased its dividend pay-out guidance, reflecting the strong cashflow that has been a hallmark of the group since it floated in 2016. Today's AGM statement confirmed "in line" trading and highlighted: "encouraging" housebuilding; good progress on the planned new brick plant; and improved productivity at the temporarily constrained Bison Precast business, acquired in 2017. We are making no changes to our estimates at this point, other than to raise our dividends by 12.5%, giving a FY 2019E yield of 4.3%.

- **Pay-out guidance raised.** The pay-out was raised to 45% for FY 2019E and the group undertook to "maintain the progressive policy thereafter". We have raised our forecast from 11.0p and 12.4p for FY 2019E and 2020E respectively to 12.4p and 13.0p. We had assumed a ratio of 40% previously, although the company had not explicitly guided to this, other than in the year of the IPO. In our view, the UK's second biggest brickmaker's most impressive feat since then has been that it has regularly beaten expectations in reducing net debt, from a pro-forma £155m (2.2x EBITDA) to £39m (0.5x) at FY 2018. The higher dividend nudges up our projected net debt from £36m and £32m for FY 2019E and 2020E respectively to £37m and £36m.
- **"In line" trading and "encouraging" new homes volumes.** Trading to April has been in line with management expectations, "underpinned by continuing positive activity in new build housing, with brick sales volumes modestly ahead of last year". Group revenue to end-April has been 7.8% ahead YoY, compared with our FY 2019E growth of 4.9%, bearing in mind that H1 2018 was held back by the 'Beast from the East' snowstorm. We explore volume and pricing themes on pages 2 - 4.
- **Planned new brick plant and precast business on track.** The planned £95m plant, at Desford in Leicestershire, has received planning permission and contracts are being finalised. Full production is targeted for 2022, at which point it will be the 180 brick pa plant will be the largest and most efficient brick in Europe, according to Forterra. The Bison business, bought at an attractive price from Laing O'Rourke in 2017, had experienced production hiccups but productivity improvements since Q4 2018 have continued and the business has won new contracts.
- **Valuation.** The shares are trading at a FY 2019E P/E of 10.6x and dividend yield of 4.3%. This compares to larger rival Ibstock on 12.8x and 5.5% on the same basis, according to consensus.

FYE DEC (£M)	2016	2017	2018	2019E	2020E
Revenue	294.5	331.0	367.5	385.4	402.0
Adj EBITDA	70.6	75.4	78.8	82.5	86.1
Fully Adj PBT	54.3	61.1	64.8	67.5	70.8
Fully Adj EPS (p)	21.4	24.3	26.1	27.2	28.5
EV/Sales (x)	2.1x	1.9x	1.7x	1.6x	1.5x
EV/EBITDA (x)	8.7x	8.2x	7.8x	7.5x	7.2x
PER (x)	13.4x	11.8x	11.0x	10.6x	10.1x

Source: Company Information and Progressive Equity Research estimates

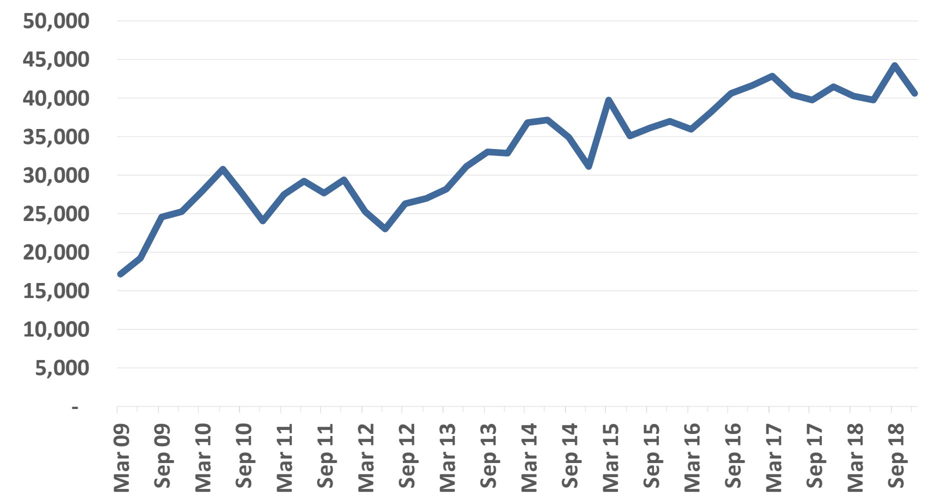
Demand-supply imbalance supports demand and prices

Housebuilding volumes – and brick – demand likely to be sustained by supportive Government policy

Housebuilding, which accounts for 65% of Forterra's revenue, in our view, looks likely to continue trending upwards in the foreseeable future. Demand currently exceeds brickmaking capacity – seen in the continued growth in imports – meaning that there should be further upwards pressure on the price of bricks, we believe.

We have consistently argued that the Government's commitment to supporting housebuilding volumes will support demand for bricks and other basic housing materials (see Pump up the volume, 25 January). Despite the current focus on Brexit, housing starts in England (the most up to date, Scottish and Welsh are published later) have held fairly steady for over two years (see below) – largely supported by the Government's Help to Buy support package, which has been extended from the latest cut-off of 2021 to 2023, albeit then restricted to first time buyers,

Housing starts, England, SA



Source: Ministry of Housing, Communities and Local Government

Largest builders point to modest increases in volumes …

Major housebuilders indicate modest but sustained growth in volume, with larger private developers and housing associations more dynamic

In the latest round of trading statements, the leading quoted housebuilders indicated at least low single digit percentage growth in volumes in the forthcoming year, with Bellway and Countryside steering towards mid-high single digits.

- **Barratt Developments** (latest FY, 16,680 completions): trading statement. "Strong" performance since start of calendar year; continue to expect volume growth in FY 2019E towards the lower end of medium-term guidance (3 - 5%). FY results expected to be "modestly above" board's previous expectations.
- **Persimmon** (16,449): Trading statement. Orders flat, expect similar completions in H1 2019E (to June) to last year, as site openings are restricted following quality control concerns
- **Taylor Wimpey** (14,822): Trading statement. Given "strong" sales performance, "expect full year [to December] volumes to be slightly higher than 2018", but higher than expected build cost inflation is likely to put pressure on margins
- **Bellway** (10,307): H1 results. Volumes +5.6%. "Further volume growth is expected both this financial year and over the longer term", after investment in newer divisions

- **Countryside Properties** (4,295): HY results. Completions +43%. Strong current trading and "on track to deliver volume and margin expectations for the full year".

In addition to the modest increases in volumes suggested by the largest builders, we believe larger expansions are being planned by some of the larger unquoted private housebuilders and also many of the largest housing associations. On top of this local authorities have been allowed to borrow to fund additional housebuilding for the first time since the tide turned against council housing in the Thatcher years.

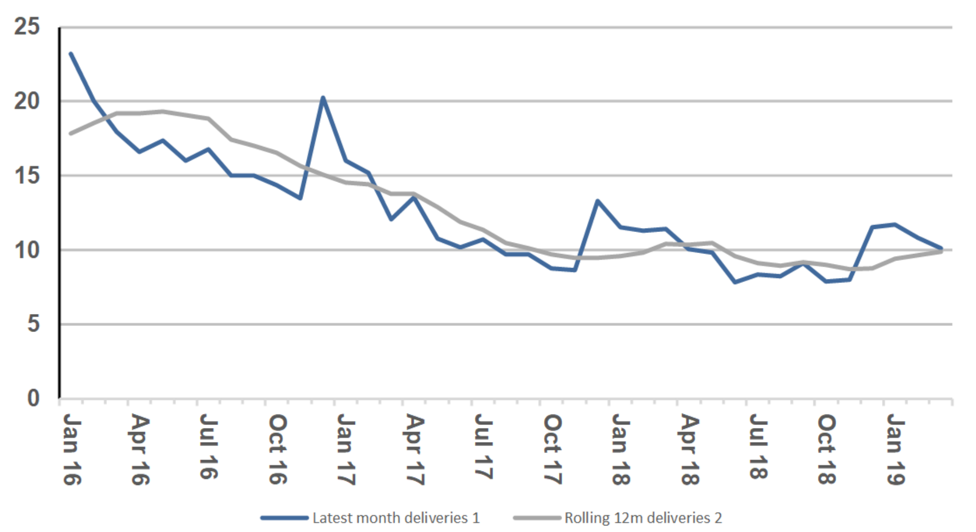
… and bigger rises in prices?

Largest housebuilders draw attention to brick price rises, fuelled by low industry stock levels

In addition to the generally supportive volume outlook, one of the key features of the conference calls during the latest statements was strong increases in the price of bricks, for instance: "in bricks, we've seen substantial increases" (Barratt) and "we've seen mid- to high-single digit price rises on bricks" (Countryside).

The main reason in our view continues to be the imbalance between demand and industry capacity. In the past three years, average industry stock levels, expressed in weeks of deliveries, have halved to around 10 weeks (see below). This is despite increases in capacity at Ibstock (a new c. 100 m brick pa plant now fully commissioned) and incremental expansions of productions at a number of Forterra's factories.

Brick stocks / deliveries (weeks)



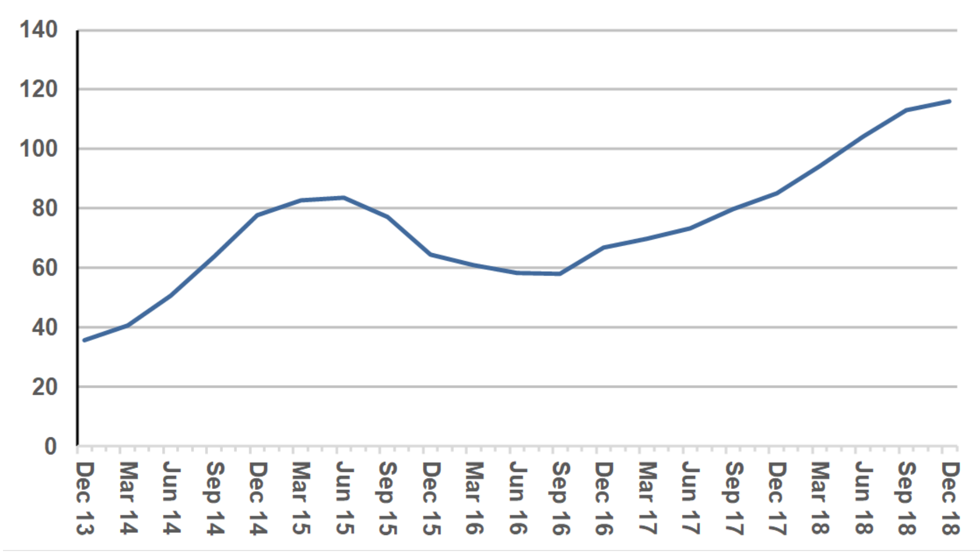
Source: Department for Business, Energy & Industrial Strategy. [1] 52 x Latest month of stocks / latest month of deliveries; [2] latest month / trailing 12 m deliveries

The level of tight supply can be seen in the continuing upwards trajectory of imports (see below). We assume that a sizeable proportion of these imports have been specified by architects and commercial developers due to their particular sizes, shapes or colours, but it appears clear that availability is tight across the sector.

In the AGM statement, Forterra maintained its previous stance, that price rises are offsetting its own increases in input costs and that price increases for the year have been agreed with most customers.

Imports rise to new highs for this cycle

Imports of bricks, annualised (£m)



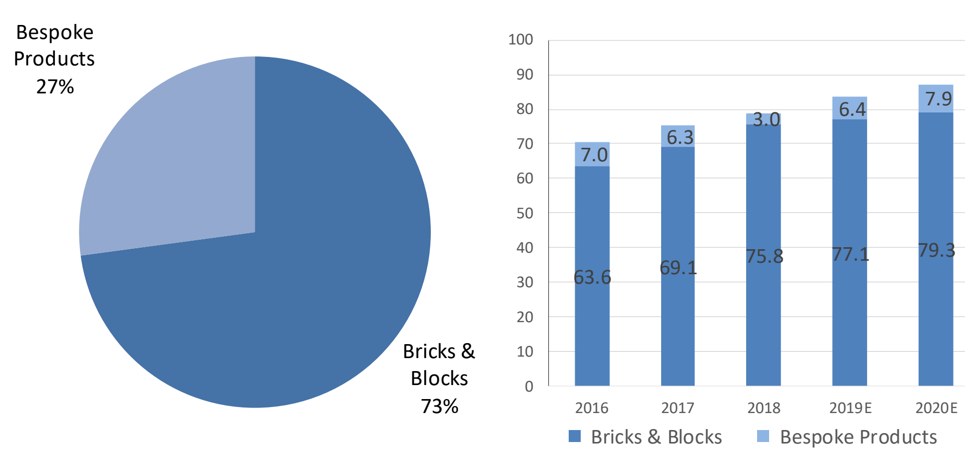
Source: Department for Business, Energy & Industrial Strategy

Forterra in brief

Forterra is the UK's second largest brick manufacturer, after Ibstock, and is also a major producer of concrete blocks and a range of concrete and clay paving, flooring, drainage and other products. Its current brick capacity is 590 million pa, approximately 29% of UK capacity, which is dominated by these two, Wienerberger and Michelmersh in distant fourth. It is entirely UK-focused and its main end-use is in the residential new building and refurbishment markets

The group comprises the rebranded UK building products activities of the old Hanson conglomerate. Having been acquired eventually by US private equity group Lone Star, the UK business was listed on the London Stock Exchange on 21 April 2016 at 180p, valuing the group at £360m.

Table 2: Divisional revenue, 2018 (%) LHS; EBITDA, 2017 – 20E, £m (RHS)



Source: Company Information and Progressive Equity Research estimates

Financial Summary: Forterra

Year end: December (£m unless shown)

PROFIT & LOSS	**2016**	**2017**	**2018**	**2019E**	**2020E**
Revenue	294.5	331.0	367.5	385.4	402.0
Adj EBITDA	70.6	75.4	78.8	82.5	86.1
Adj EBIT	60.2	64.5	67.1	70.0	73.6
Reported PBT	37.1	59.3	64.8	67.5	70.8
Fully Adj PBT	54.3	61.1	64.8	67.5	70.8
NOPAT	47.7	52.0	54.7	57.0	60.0
Reported EPS (p)	13.8	23.8	26.5	27.6	29.0
Fully Adj EPS (p)	21.4	24.3	26.1	27.2	28.5
Dividend per share (p)	5.8	9.5	10.5	12.4	13.0
CASH FLOW & BALANCE SHEET	**2016**	**2017**	**2018**	**2019E**	**2020E**
Operating cash flow	56.2	90.2	79.8	80.5	84.1
Free Cash flow	28.8	69.2	49.5	53.5	56.2
FCF per share (p)	14.4	34.6	24.8	26.8	28.2
Acquisitions	(0.1)	(21.8)	(2.1)	0.0	0.0
Disposals	N/A	N/A	N/A	N/A	N/A
Shares issued					
Net cash flow	32.0	(27.2)	(3.0)	2.2	0.5
Overdrafts / borrowings	148.5	89.8	64.8	64.8	64.8
Cash & equivalents	56.2	29.0	26.0	28.2	28.7
Net (Debt)/Cash	(92.3)	(60.8)	(38.8)	(36.6)	(36.1)
NAV AND RETURNS	**2016**	**2017**	**2018**	**2019E**	**2020E**
Net asset value	69.2	104.7	134.2	166.9	198.9
NAV/share (p)	34.6	52.2	66.9	83.2	99.1
Net Tangible Asset Value	55.5	88.9	116.9	149.6	181.6
NTAV/share (p)	27.8	44.3	58.3	74.6	90.5
Average equity	(219.5)	(70.7)	87.0	119.5	150.6
Post-tax ROE (%)	(12.5%)	(67.2%)	60.7%	46.0%	38.3%
METRICS	**2016**	**2017**	**2018**	**2019E**	**2020E**
Revenue growth	N/A	12.4%	11.0%	4.9%	4.3%
Adj EBITDA growth	N/A	6.8%	4.5%	4.6%	4.4%
Adj EBIT growth	N/A	7.1%	4.0%	4.3%	5.2%
Adj PBT growth	N/A	12.5%	6.1%	4.1%	4.9%
Adj EPS growth	N/A	13.5%	7.4%	4.1%	4.9%
Dividend growth	N/A	63.8%	10.5%	18.3%	4.9%
Adj EBIT margins	20.4%	19.5%	18.3%	18.2%	18.3%
VALUATION	**2016**	**2017**	**2018**	**2019E**	**2020E**
EV/Sales (x)	2.1	1.9	1.7	1.6	1.5
EV/EBITDA (x)	8.7	8.2	7.8	7.5	7.2
EV/NOPAT (x)	12.9	11.8	11.3	10.8	10.3
PER (x)	13.4	11.8	11.0	10.6	10.1
Dividend yield	2.0%	3.3%	3.7%	4.3%	4.5%
FCF yield	5.0%	12.0%	8.6%	9.3%	9.8%

Source: Company information and Progressive Equity Research estimates

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