

fatPROPHETS™

1300 881 177

James Hardie

15/08/2017 FAT-AUS-835

JHX

AUD \$17.66

Core

HIGH**B**

Looking for capacity

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We however remain positive on the company's ability to grow earnings at a robust rate, based on a number of fundamental factors. Firstly, we believe that the US housing market itself has further legs, with interest rates set to rise at a much more gradual rate than the consensus currently expects. There is also significant political will on Capitol Hill to ensure that this is the case, and that the real estate market continues to trend upwards.

Given our view that the US property market has not peaked, we believe James Hardie is well positioned. While capacity restraints have been an issue, we continue to view this as an operational hurdle that can be surmounted (but for which little credit is being ascribed), and is not down to mismanagement. The company also has a strong capital position from which to support earnings growth over the next 12-18 months.

Accordingly, James Hardie will remain held in the Fat Prophets portfolio. For Members without exposure, and taking a longer term view, we remain comfortable with continuing to recommend the stock as a buy around current levels.

First quarter results and AGM

James Hardie held its Annual General Meeting last Tuesday, alongside first quarter results, and it is fair to say these were not well received by the market. The shares lost almost 6 percent on the day and drifted lower amidst broader market weakness in subsequent trading sessions. The shares have stabilised, and picked up slightly this week, although we believe that the recent sell-off has in any event been overly harsh.

The building products manufacturer saw net profit attributable to shareholders fall some 34 percent to US\$57.4 million. Adjusted net operating profit of US\$61.7 million for the first quarter was down 7 percent on the prior period. Group net sales were up 6 percent to US\$507.7 million, highlighting the pressure that was seen at the margin.

James Hardie Industries plc
Results for the 1st Quarter Ended 30 June

US\$ Millions	Three Months Ended 30 June		
	FY18	FY17	Change %
Net sales	\$ 507.7	\$ 477.7	6
Cost of goods sold	(338.7)	(300.9)	(13)
Gross profit	169.0	176.8	(4)
Selling, general and administrative expenses	(73.5)	(72.0)	(2)
Research and development expenses	(7.6)	(7.6)	—
Asbestos adjustments	(3.9)	20.6	
EBIT	84.0	117.8	(29)
Net interest expense	(6.5)	(6.1)	(7)
Other expense	(0.4)	(0.7)	43
Operating profit before income taxes	77.1	111.0	(31)
Income tax expense	(19.7)	(23.9)	18
Net operating profit	\$ 57.4	\$ 87.1	(34)
Earnings per share - basic (US cents)	13	20	
Earnings per share - diluted (US cents)	13	19	
Volume (mmsf)	690.2	672.9	3

Source: Company announcement

Management now expects full year adjusted net operating profit to come in between US\$240 million and US\$280 million for the full year to 31 March 2018. This compares to the average analysts forecasts prior to the announcement of between US\$248 and US\$297 million, and US\$248.6 million in FY17. While a lowering of guidance, what also likely spooked investors was management's view that market conditions were somewhat 'uncertain' and input costs 'volatile.'

Ironically, given all the concern over the state of the Australian housing market, the 'domestic' fibre cement business performed well, with earnings for the unit up 31 percent in the quarter. Higher volumes and net sales prices boosted the bottom line. Admittedly though, we are less confident about the outlook in Australia going forward, and management also noted that detached housing approvals (a key driver of sales volumes) have weakened. Overall, the 'international' fibre segment (which includes Australasia and the Philippines) saw EBIT rise 10 percent to US\$26.2 million.

US\$ Millions	Three Months Ended 30 June		
	FY18	FY17	Change %
Volume (mmsf)	128.7	124.5	3 %
Average net sales price per unit (per msf)	US\$766	US\$754	2 %
Net sales	110.8	102.9	8 %
Gross profit			12 %
Gross margin (%)			1.5 pts
EBIT	26.2	23.9	10 %
EBIT margin (%)	23.6	23.2	0.4 pts

Source: Company announcement

About 80 percent of James Hardie's sales though are generated in North America, where the fibre cement business saw a 16 percent decline in earnings to US\$79.8 million. Higher production costs were a feature, but capacity constraints have also been an issue.

US\$ Millions	Three Months Ended 30 June		
	FY18	FY17	Change
Volume (mmsf)	561.5	548.4	2 %
Average net sales price per unit (per msf)	US\$693	US\$665	4 %
Net sales	393.1	370.3	6 %
Gross profit			(9)%
Gross margin (%)			(5.2 pts)
EBIT	79.8	94.6	(16)%
EBIT margin (%)	20.3	25.5	(5.2 pts)

Source: Company announcement

On the plus side, volumes were 2 percent higher, while average net selling prices rose 4 percent. This in our view goes to the strength of the US housing market, and also the degree of pricing power which James Hardie has. Given our view that the Fed will be much slower in raising rates than many think (and such a slow trajectory will be promoted by Donald Trump), we believe that the conditions will remain favourable.

Management at James Hardie have talked about 'uncertainty' but this is not surprising given there is a general absence of that with respect to where rates are heading, and how quickly. If we are right though, bricks and mortar (and cement!) should continue to see robust buying in the US.

Gross margins at the unit did fall 5.2 points to 20.3 percent, with higher production costs an issue. These were driven by increased spending in freight, labour and maintenance. Production and freight inefficiencies were also driven by constraints in the company's inventory. EBIT for the quarter fell by 16 percent, driven by a 9 percent decrease in gross profit and a 7 percent increase in selling, general and administrative expenses.

While this is not an ideal state of affairs for the company's main division, the problems have been recognised, and can be fixed in our view. Management's concerted focus for the year will now be on increasing manufacturing capacity to "drive return on capital and improve the performance of the North American manufacturing network."

The company expects the performance in North America to improve through fiscal 2018, and we have a degree of confidence here given our overriding thematic view and management's track record. James Hardie expects new construction starts to be between 1.2 and 1.3 million. With US housing starts currently around 1.2 million we don't think this forecast is overly optimistic, and given the long-term trend as shown below.

US New housing starts last 20 years



The company also believes that it can achieve an EBIT margin in the North America fibre segment in the range of 20 percent to 25 percent for fiscal 2018. Should management address the capacity constraints as we expect, and given pricing power, we expect margins can push up from the bottom end of the range.

From a balance sheet point of view, James Hardie certainly has a degree of financial flexibility. Cash increased from US\$78.9 million a 31 March 2017 to US\$112.3 million at 30 June 2017. There is also US\$350 million available of a US\$500 million revolving credit facility.

James Hardie also continues to meet its commitments to the Asbestos Injuries Compensation Fund (AICF) which amounts to 35 percent of free operating cash flow. The company has thus far contributed over A\$1 billion to the fund since 2007.



Turning to the charts, and from the daily chart, the bearish moving average crossover present since June is initially suggestive of momentum to favour the downside. This is when the 50-day moving average (red line) crosses below the 200-day moving average (green line). Should the bears remain in control over the near-term, then support is expected at the August intra-month low of \$17.17 (horizontal blue line).

Positively, from a relative strength (RSI) perspective, this indicator has moved into oversold territory, which is suggestive of an exhaustion in short-term selling pressure, and hence, would be fair to say that an interim low/turning point is near. In order for the short-term technical landscape to improve, a sustained break above the 50-day moving average (red line) of \$19.33 is required. Should this occur, then momentum would once again swing in favour of the bull-camp.



With reference to the monthly chart, prices have closed (on a monthly-basis) above the 78.6% Fibonacci retracement of \$21.96 in April. This is a bullish development and now activates two additional upside targets. The initial target is situated at the 127.2% Fibonacci extension of \$24.53, followed by the 161.8% Fibonacci extension of \$26.36. Though, over the near-term, a period of weakness is evident. Dynamic support is situated at the \$17.00 region (long-term uptrend line) which would likely limit further downward pressure. Overall, the long-term uptrend remains intact and therefore would likely dictate the broader direction of James Hardie.

Summary

While James Hardie has been a strong performer in the Fat Prophets portfolio over the years, the last few months have not been particularly kind, with the shares pulling sharply lower from year-to-date highs. Investors have been unnerved by volatility in the US housing market, cost pressures, and a shortage of manufacturing capacity.

We however remain positive on the company's ability to grow earnings at a robust rate, based on a number of fundamental factors. Firstly, we believe that the US housing market itself has further legs, with interest rates set to rise at a much more gradual rate than the consensus currently expects. There is also significant political will on Capitol Hill to ensure that this is the case, and that the real estate market continues to trend upwards.

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surmounted (but for which little credit is being ascribed), and is not down to mismanagement. The company also has a strong capital position from which to support earnings growth over the next 12-18 months.

Accordingly, and with the shares trading at around 19 times FY18 earnings, James Hardie will remain held in the Fat Prophets portfolio. For Members without exposure, and taking a longer term view, we remain comfortable continuing to recommend the stock as a buy around current levels.

Disclosure: James Hardie is held within the Fat Prophets Concentrated Australian Share and Australian Small & Mid Cap Models.

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Snapshot JHX

James Hardie

Latest Closing Price: \$17.66

James Hardie Industries is a manufacturer of fibre cement products and systems for internal and external building construction applications in the United States, Australia, New Zealand, and the Philippines. Its fibre cement products are used in a number of markets, including new residential construction (single and multi-family housing), manufactured housing (mobile and pre-fabricated homes), repair and remodelling and a variety of commercial and industrial applications. It manufactures numerous types of fibre cement products with a variety of patterned profiles and surface finishes for a range of applications.

Market Capitalisation: \$7.7b

	FY1	FY2

Price to Earnings	23.1	19.3
Dividend Yield (%)	3.0%	3.4%

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