fatPROPHETS™ 1300 881 177

Norcros 22/03/2018 **FAT-UK-726**

NXR GBP £1.950 Special **HIGH** S

Fat Prophets take Profits

Since announcement of the Brexit referendum in 2016, the UK's property market has started to sputter as property price inflation lost momentum while the construction sector has also seen warning signs. Members following our reports on the UK property space over the past month would know that we have been making an orderly exit from the sector, starting with Travis Perkins and today we add another to list with the recommendation to exit building products maker, Norcros (LSE: NXR).

A Quick Recap and What's New?

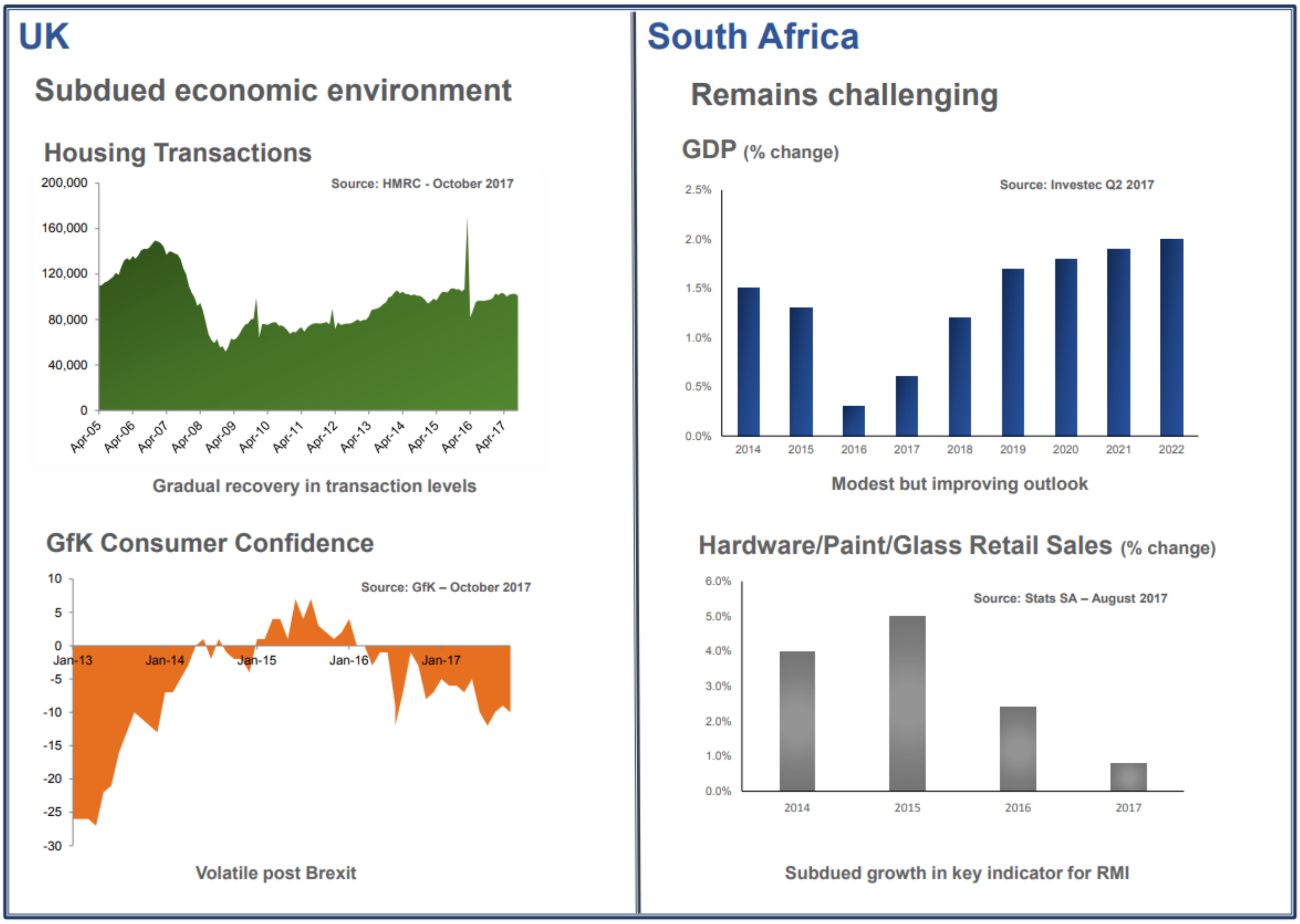
In our previous coverage of the company back in December (FAT-UK-714) we focussed on the company's Interim Results (ending 30 September 2017) where management noted the steady progress in South Africa while the company's UK business reported higher revenues as a result of increased marketing spend.

The successful acquisition of Merlyn Industries for £60 million was also seen as a net positive with the previous acquisitions proving to be accretive and this likely to synergise well with the group.

Despite that, however, underlying operating profit in the UK did not follow suit as the higher marketing spend and a weak performance in Tiles and Showers product lines dragged down operating margins by 140 basis points to 7.2%, leading to an underlying profit of £7.4 million, down 7.5% year-on-year.

Though at the time, our view was still relatively positive on the sector as many companies were still reporting reasonable performances and the business outlook (based on IHS Markit research) was improving.

However, this did not seem to be the case as subsequent economic reports from various sources have been pointing towards a weakening property market. In fact, management even provided some hints in their Interim presentation that the sector was already slowing down. The graphic below summarises the broad picture view of the company:

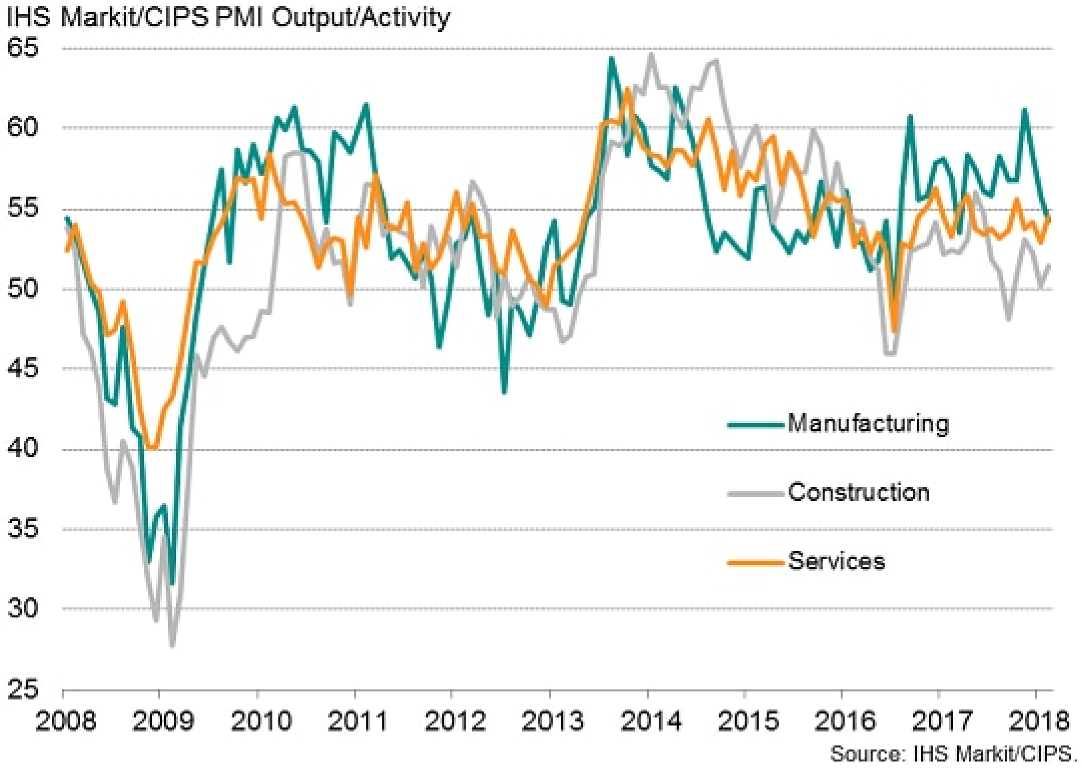


Source: 16 November 2017 Company Presentation

As shown in the graphic above, housing transaction and consumer confidence have been weakening while it wasn’t all sunshine in South Africa either as retail sales of affiliated products have dropped gradually since peaking in 2015.

Since then, and as we have reported on the sector over the past month with notes on Travis Perkins, Bovis Homes, Barratt Developments, Rightmove and U&I, more and more data is surfacing that the property boom is over.

The latest sector data shows that the construction sector has hit another rough patch in February. According to a report from the IHS Markit on the construction sector, PMI data has inched up from a 4-month low of 50.2 in January to 51.4 for February 2018. Though a slight improvement, this is still below the 52.3 average seen in 2017 which was already weak considering the boom period starting in 2013.



Source: IHS Markit

The devil, however, is in the details as the reason for the increase in the metric came in from a recovery in Masonry which has been in the doldrums since May 2017 and only due to timing of commercial projects. The more relevant data, in our view, is actual demand from residential (which forms the bulk) and the pipeline of orders, which both registered their weakest results for the rolling 3-month period.

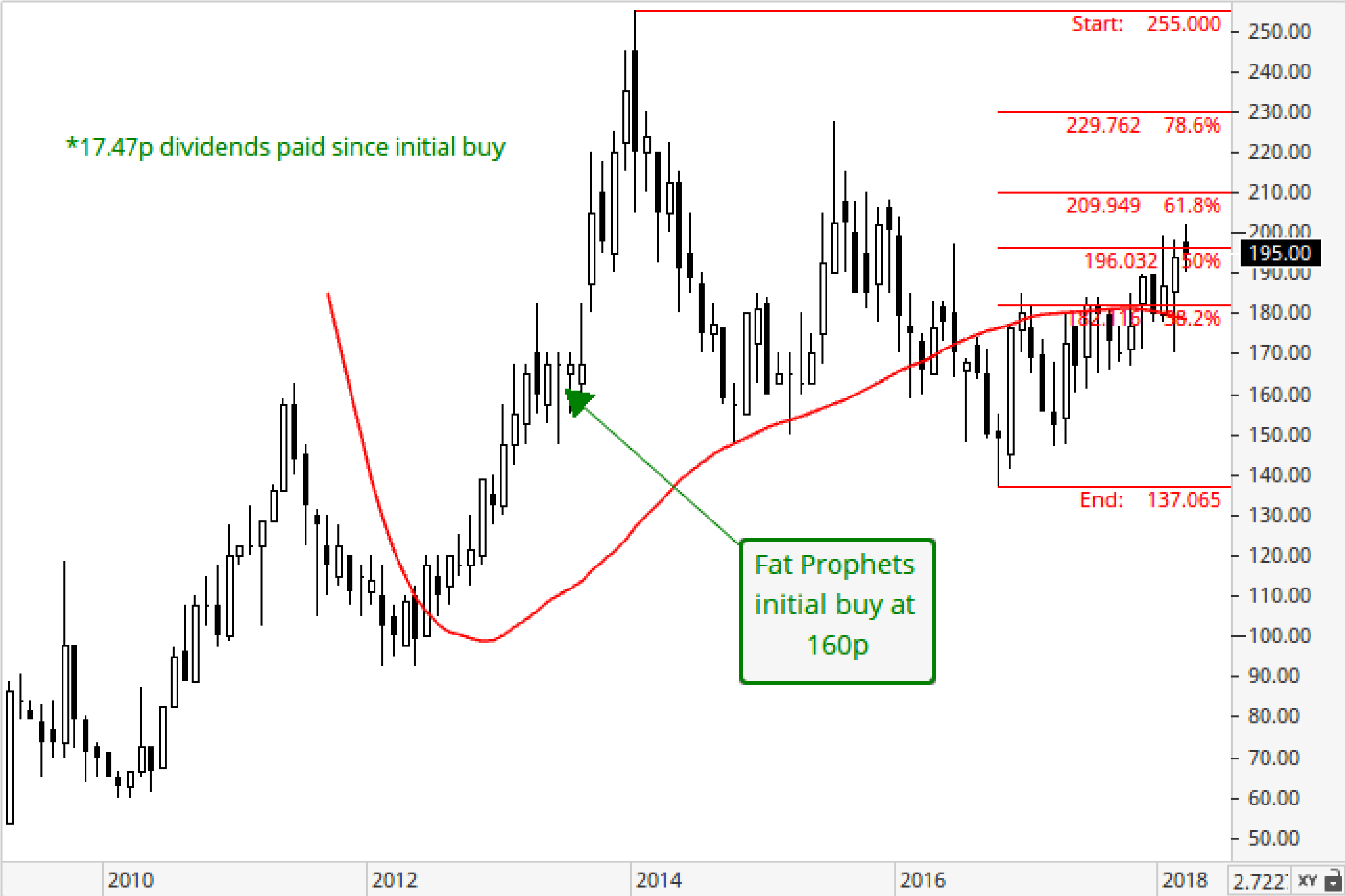
This in turn also worsened business confidence as Brexit-related uncertainty dried up the pipeline to replace completed projects, while strong input cost pressures from higher raw material prices, fuel bills and staff wages tightened margins even more.

As we've noted, cost inflation would be manageable if it could be passed to consumers, however, many properties in the market are already pricing buyers out given that the boom has pushed average prices to over 8-10 times annual income while in London this could hit circa 40 times annual earnings, sparking a nationwide affordability crisis.

Mortgage approvals have also continued to worsen with February data showing a 2.6% fall year-on-year to 66,364 approvals. This could fall further as rate hike from the Bank of England may price more out of the market.

Finally, the Office for National Statistics released a report that actual output from the construction sector had its worst monthly performance since June 2012, falling 3.4% month-on-month in January 2018. This was also worse than the 0.3% contraction that was expected by consensus estimates. On a rolling 3-month basis, the metric also showed a 1% contraction and is its 9th consecutive period of decline. According to the report, the main drag came from the private sector which held off construction work due to Brexit fears.

Norcros Plc - NXR (LSE) - 1 Month CandleStick Chart - GBP



Summary

All in all, the property market in the UK has continued to weaken with the pipeline of work drying up ahead of the Brexit as consumers hold off their purchase. Furthermore, rising costs of inputs and already stratospheric high property prices will squeeze profits across the sector which combined could lead to declining earnings expectations.

Though Norcros has yet to provide a trading update (due Mid-April) to cover the period after September (Interim), given the numerous changes in the industry that have taken place, we believe it is prudent to lock in profits and exit while still ahead of the curve.

Accordingly, we recommend to Members SELL their position in Norcros at current levels. The stock will be removed from the Fat Prophets portfolio.

Snapshot NXR

Norcros

Latest Closing Price: £1.95

Norcros is engaged in the development, manufacture and marketing of home consumer products in the United Kingdom, South Africa and others. The company operates under four brands: Triton Showers, Johnson Tiles, Vado (taps, shower mixers and accessories) and Norcros Adhesives.

Market Capitalisation:£155.90m

	FY1	FY2
Price to Earnings	6.9	6.5
Dividend Yield (%)	4.0	4.3
Return on Equity (%)	16.3	18.6
EV/EBITDA	5.2	4.4