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Australian Equities

# Snatching defeat from the jaws of victory – James Hardie

In this article, Craig McCourtie from our Australian Equities team provides an in-depth analysis of James Hardie's proposed acquisition of the US listed decking business, Azek. This deal has sparked significant debate within the industry due to the high price being paid and its potential impact on shareholder returns. In the article below we share our view and discuss our portfolio response.

Australian investors typically view company acquisitions with some scepticism. However, James Hardie's proposed acquisition of the US listed decking business, Azek, has faced significant and widespread criticism.

Azek operates within the building products sector, specialising in decking. We have met with the company multiple times in recent years and view it as a high-growth, well-managed company that aligns with Northcape's quality criteria. The primary concern with the acquisition is the substantial price James Hardie is paying. This significantly impacts the high returns currently enjoyed by Hardie's shareholders, such that in the near to medium-term we expect returns will struggle to meet the cost of capital. The market has heavily penalised the share price as a result, with 5% outperformance turning into 20% underperformance to the end of March.

## Our assessment of the potential synergies

James Hardie's Management and Board are promoting the deal based on potential for a multiple re-rating towards the significantly higher Azek multiple (EBITDA); $325 million of EBITDA synergies, two-thirds of which are revenue-based; and the advantage of having more size and products to counter consolidating distribution channels. While we acknowledge the cost synergies, we have reservations about other aspects of the deal. In particular, the market has expressed significant scepticism regarding the revenue synergies, and we agree.

Typically, revenue synergies are challenging to achieve and often fall short of expectations. Cross-selling products across two large sales forces with specialized skills in either siding or decking will be difficult. We question the feasibility of this.

While Azek's composite wood alternative and Hardie's fibre cement are leading products in their respective spaces, selling both siding and decking projects to a homeowner at the same time can be a challenge due to the high costs involved. It is more likely for a homeowner to secure one project but not the other. Hardies may need to revisit the homeowner years later to secure the second project. From a repair perspective, wooden decks and siding may need replacement within a similar timeframe, but cost considerations remain.

We have met with numerous building industry participants in recent weeks and discussions have reinforced the belief that revenue synergies will be difficult to execute. Consequently, we are assuming well below half of the projected revenue synergies in our calculations.

The most disappointing aspect of the deal is that it was unnecessary. As a stand-alone company, James Hardie had a long runway of growth and was well-positioned for when the cycle turned. It would have delivered exceptionally high returns on incremental capital spend to achieve its stated growth objectives. However, the deal has introduced execution and balance sheet risk by increasing leverage at an uncertain time in the cycle. And for what? A couple of extra points of revenue growth and a margin outcome that is likely slightly less than the existing

margin. On a risk/return basis, it does not stack up for shareholders.

## Why Azek and why now?

When management began discussing potential acquisitions last year, we considered Azek the logical strategic option. However, after analysing what the Azek shareholders would need to be paid, we concluded that the deal made no financial sense for James Hardie shareholders.

So why proceed with the deal, and why now? Under the deal, Hardies will move their primary listing to the NYSE, avoiding ASX listing rules and stricter Australian Governance standards. The stock will still be listed on the ASX (as a CDI) and included in the local indexes, but over time, its weight is likely to decline as more trading volume and ownership shifts to the US. The timing appears opportunistic, as the prevailing Azek share price has been under pressure, along with other housing-related investments, due to uncertainty regarding the outlook for the US economy.

## Will the deal go ahead despite investor concern?

We have done numerous calls with industry participants on the deal and our view is that it can only be stopped by the Azek shareholders, who will get a vote. James Hardie shareholders do not get to vote, and the ASX has appeared to waive listing rules that could frustrate the deal based on previous precedents. Speaking with US analysts our understanding is that these deals rarely fall through. Under Delaware law (where Azek is incorporated), Hardies has set up a special purpose vehicle through which their new shares will be distributed to Azek shareholders. Precedents show that the Delaware court system will enforce the deal even if Hardies wanted to pull out. Sadly, it does look like a done deal.

## Portfolio positioning and view on Hardies?

Northcape had a moderate overweight portfolio position in Hardies (2.7%) at the end of February and the share price decline since the announcement has had a negative impact on performance over the quarter. However, one of the many strengths of our multiple portfolio management approach is the diversity of view among portfolio managers. In the case of Hardies, only two of the four portfolio managers held the company in their portfolio slice, which they had been trimming based on a slower recovery in the building cycle.

## Where do we stand now?

Based on the data received so far, we have downgraded earnings for FY '26 and FY '27 by 10%. Management believes the deal will be earnings accretive in FY'27, but we struggle to reach these numbers, given our scepticism regarding revenue synergies.

We have significantly lowered our view on the quality of the business. Our confidence in management's ability to appropriately allocate capital in shareholders' best interests has decreased. From a governance perspective, we feel the Board's oversight of the transaction did not duly consider the associated risks. Reflecting this view, we have trimmed our position.

That said, the combined company will have two very good operating businesses, with solid growth prospects given the underlying structural needs of the housing markets they operate in. The precipitous share price decline of 32% since the announcement, leaves James Hardie, even incorporating no revenue synergies, very cheap on fundamentals and for now we are comfortable with our lower portfolio weighting.

For more information, please contact our distribution team:

**Katie Orsini**
**Client Director**

p: +61 2 8234 3629
e: katie.orsini@northcape.com.au

**Wendy Hammond**
**Senior Manager, Client Development**

p: +61 2 2 8234 3638
e: wendy.hammond@northcape.com.au

## Northcape Capital

**Sydney**
Level 24, 45 Clarence
Street Sydney NSW 2000
Australia
P: +61 2 8234 3600

**Melbourne**
Level 18, 90 Collins Street
Melbourne VIC 3000
Australia
P: +61 3 8626 8000

ABN: 53 106 390 247
AFSL: 281767

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