Thompson Research Group

Cabinet Trends Extremely Positive:

Views on Future & Impact on Stocks

June 9, 2021

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Please see pages 5-6 for Important Disclosures

Cabinetry Demand Accelerating, Conditions Ripe for Further Improvement

TRG Takeaways/Opinion: Throughout 2020, cabinetry was one of the most challenged products despite the strength in housing and housing products, as more time was spent in homes and people were eating in (vs. eating out). Many homeowners did not want contractors in their homes due to social distancing, and kitchen and bath projects are more disruptive to daily life. Ironically, these factors were what sparked our view that kitchen and bath remodels would go into the "pent up" demand category, and be in greater demand as homeowners got more comfort in having contractors in their homes. We believe recent data points reflect this prediction playing out (KCMA data, FBHS, AMWD, NX reports/comments, as well as TRG channel checks).

Recent data and perspectives – NX, AMWD, FBHS, and KCMA data:

- **Quanex (NX, $27.68) North America Cabinets (NAC):** Last three quarters showed solid YOY growth (+6%, +8%, +26%), after five quarters of YOY declines. This reflects the return to growth in semi-custom cabinetry, which NAC is primarily dependent upon. NX expects NAC to display 15% YOY growth in FY'21 (ending Oct), which points towards solid growth in the next couple of quarters.
- **American Woodmark (AMWD, $84.88):** In the most recent quarter (Q4'21 ending April), total sales +19% YOY. New construction grew 13%, R&R grew 22%. Within R&R, HCs grew 25% and dealer/distributor grew 13%. AMWD expects sales in Q1'22 to be up mid/high-teens.
- **Fortune Brands (FBHS, $102.54):** Sales +11% YOY in Q1'21, noting that demand was strong in all categories and this strength points to consumers' willingness to undertake big-ticket R&R projects.
- **KCMA data (slide 4):** Sales dipped dramatically in April/May 2020, down slightly in June 2020, but have been up on a YOY basis every month since that time, with double-digit growth in four of the past six months reported (Dec, Jan, Mar, Apr). In a reversal of trends, semi-custom and custom cabinetry have shown much stronger growth and re-gained some incremental share from stock.

Macro context for home spending – positive:

- **More time spent in homes permanently:** Even as the economy re-opens, there is a higher level of WFH. We believe, generally, people spend money where they are and where they're going to be. This has and will continue to drive homeowners to spend money on their homes.
- **Rising home equity on rising home values:** Home prices have moved higher, as a greater % of U.S. citizens want to own a home versus rent. There are not many homes for sale. Rising home values has caused a re-financing boom, putting more money in people's pockets. Furthermore, rising prices and bidding wars are influencing homeowners to stay put versus move. All of these factors provide an incentive for homeowners to spend on upgrading homes, instead of moving. Kitchen and baths will get a large portion of these dollars, inevitably.
- **The consumer is strong and has more firepower leftover:** Consumers are spending more, but savings rates are elevated and the CEO of Bank of America recently stated that they believe their consumers have only spent 30-35% of the last two rounds of their stimulus checks. This provides a positive outlook on future consumer spending.

TRG views on investing into this trend (slide 3):

- **AMWD** is the pure-play, and we believe for those who are patient and willing to look through the current inflationary pressures, that there is meaningful upside. **FBHS** is the strongest and broadest resi products manufacturer, and has meaningful sales and margin expansion opportunity in Cabinets. However, the bulk of profitability comes from higher margin segments. **NX** is least dependent upon cabinets, is the least meaningful lever to total company results.

Specific Stocks & How They May Be Impacted

TRG views on investing into this trend:

- **Cabinets % of sales: AMWD ~100%, FHBS ~40%, NX 24-25%**
- **What they all have**: All should benefit to a degree from increased cabinet demand, though NX is more focused on semi-custom demand. All have margin expansion opportunity, but there are differences in how they get there.

AMWD – pure-play / HCs / margin upside: AMWD plays across the spectrum and derives just under half of sales from HCs, along with exposure to new construction. We like this combination. AMWD also just restructured their debt on highly favorable terms, which saves ~$12MM/year on interest expenses and authorized a $100MM buyback. Therefore, we believe there will be greater capital returns going forward.

- **Near-term headwinds = inflation (but pricing) and demand exceeds sales (capex):** Inflation has been and will remain a headwind for another couple of quarters, but was especially intense with incremental costs from the TX freeze impact. The TX impact is in the midst of moderating. Pricing is implemented in dealer/distribution and new construction, while negotiations are well underway with HCs and are expected to go into effect in Q1'22. Orders are exceeding shipments, despite the company raising production levels in their recent quarter. AMWD expects capex to be ~4% of FY'22 sales (ERP, automation, other capacity expansion projects).
- **Looking through = better margins and more free cash flow:** Management still targets a long-term EBITDA margin of 14-15%, which we expect progress on due to operating leverage from strong volumes and pricing increases coming through on incremental sales. We also expect lower capex as a % of sales relative to FY'22 guide (FY'17-21 average = 2.5% of sales). Our estimates over the next two years reflect sales growth (+9%, +7% YOY), with margins slipping in FY'22 (-20 bps to 12.6%), but expanding in FY'23 (13.7%).
- **AMWD long-term outlook (to FY'26):** Sales CAGR +6% to $2.3B, EBITDA +9% CAGR to $335MM, FCF +7% to $150MM.
- **TRG Fair value range:** We use ~8-9x EV/EBITDA on FY'23 EBITDA of $278MM, which implies PPS of $103-120 (upside of 23-42%).

FBHS – broad strength in products, channel, and end market: While Cabinets is largest segment by sales, it's contribution to company profits is declining as FBHS has successfully grown the higher-margin segments through organic and acquisitive means. Multiple times, FBHS has proven their ability to improve the Cabinets segment and this is in the midst of playing out as sales and margins both improved on a YOY basis in both FY'19 (9.7%) and FY'20 (10.4%). We expect greater than 12% in the next two years. We expect the two higher-margin segments (Plumbing and Outdoor & Security) to continue their higher growth rate and drive an increasing % of total profits in the coming years, supported by new construction and R&R.

- **FBHS long-term outlook, Cabinets (FY'20-23):** Sales CAGR +7-10%, EBIT margin ~14%.
- **TRG Fair Value Range:** We use ~21x our FY'22 EPS of $6.22, which implies PPS of $131-133 (upside of 29-31%).

NX – semi-custom dependent, but least impact to total earnings power: NX is least dependent on cabinets (lowest sales and lower EBITDA contribution), but is the segment with greatest potential for margin improvement. We expect NAC EBITDA margins to be in excess of 6% in FY'23 (expect total company EBITDA margin of 12.8% in FY'23). We expect strong housing demand to be intrinsically be accompanied by labor challenges, which could drive more manufacturers to outsource elements of their production, which would benefit NX.

- **TRG Fair Value Range:** We use 7-8x EV/EBITDA on FY'22 EBITDA of $139MM, which implies PPS of $29-33 (upside of 5-20%).

Key Tables: Cabinet Trends & Comments

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Good for FBHS & AMWD as they participate in all price points/categories

****Stock was strongest performer prior to 2020 – good for FBHS/AMWD, negative for NX***

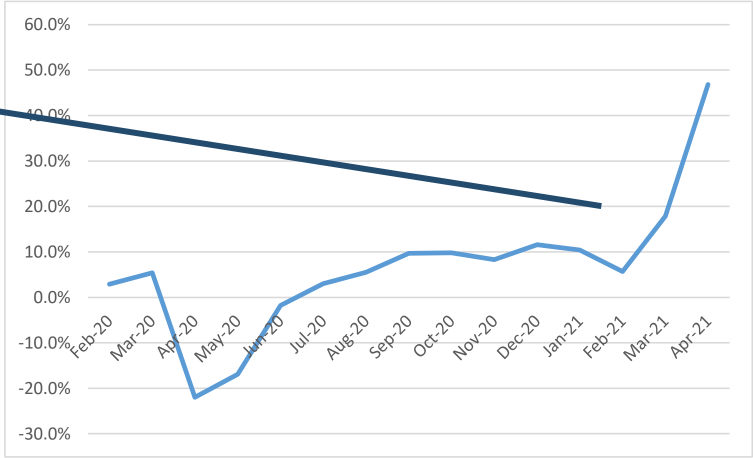
****Semi-custom demand rebounding strongly after being***

****Positive for NX, who is focused on semi-custom***

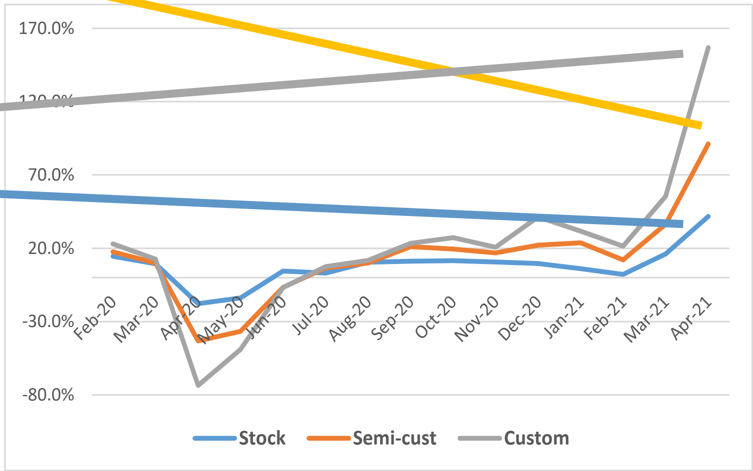
****FBHS & AMWD sell at all points of spectrum***

Source: Company Filings; TRG Research

KCMA, All Cabinets (Feb’20-Apr’21)



KCMA, Cabinet Types (Feb’20-Apr’21)



Source: KCMA Data

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Source: BigCharts.com

Important Disclosures (continued)

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