Siena Market Line
4th week of April 2015

Headwaters Incorporated

NYSE: HW

Analyst: Issam Kaisse
Sector: Basic Materials

BUY

Price Target: $20.97

Key Statistics as of 4/21/2015

Market Price:	$18.34
Industry:	Construction Materials
Market Cap:	$1.3B
52-Week Range:	$10.27-19.14
Beta:	2.54

Thesis Points:

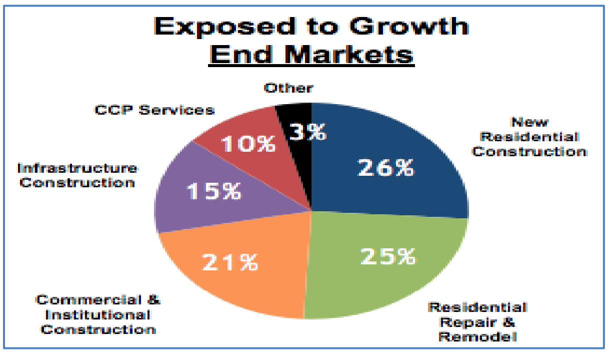
- Industry Outlook looks promising
- Leading position in the concrete market
- Diversified end markets
- Debt reduction and financial results

Company Description:

Headwaters Incorporated, a building products company, provides products and services in the light and heavy building materials sectors primarily in the United States and Canada. It operates through three segments: Light Building Products, Heavy Construction Materials, and Energy Technology. The Light Building Products segment designs, manufactures, and markets siding and exterior siding accessories, including decorative window shutters, gable vents, mounting blocks for exterior fixtures, roof ventilation, trim board and molding products, specialty siding products, and window well systems; professional tools, such as portable cutting and shaping tools; manufactured architectural stone products; specialty roofing products; and concrete-based masonry products comprising standard grey blocks, split and ground face blocks, and polished and textured blocks. This segment sells its products under the Eldorado Stone, Dutch Quality Stone, StoneCraft, InSpire, Aledora, Gerard, and Allmet brand names. This segment distributes its products through a network of distributors, such as masonry and stone suppliers, roofing and siding material distributors, fireplace suppliers, and other contractor specialty stores, as well as through national and regional retail home centers and direct sales. The Heavy Construction Materials segment manages and markets coal combustion products (CCP), including fly ash that is used as a replacement for Portland cement in various concrete applications, such as infrastructure, commercial, and residential construction; and provides CCP disposal services, as well as services to electric utilities related to the management of CCPs. The Energy Technology segment offers HCAT, a heavy oil upgrading technology. Headwaters Incorporated was founded in 1987 and is headquartered in South Jordan, Utah.

Thesis

Headwaters incorporated is a leading construction products company. As a matter of fact, the company has been able to realize double-digit growth and achieve top-quartile margin performance. The chart below shows clearly that HW has exposure to end-markets with growth opportunities:

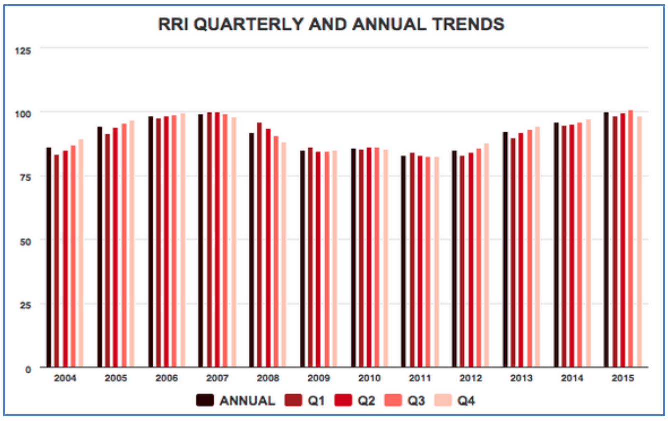


The firm is able to be a leader in high margin products because it is the best in class customer and distribution base. The company has 190 issued and pending patents, and 28 issued and pending trademarks for its products and intellectual property. The firm has been able to achieve thirteen consecutive quarters of year-over-year revenue and EBITDA growth. The stock has performed fairly well over the past year and the report will focus on proving that HW will continue to generate value in the long term. In fact, the firm is well diversified and has an important market share for many of the products they develop both nationally and internationally. Overall, Headwaters is a good long term investment opportunities with a price target of \$20.97, which is a 14.51% return.

Industry Outlook

According to the National Association of Home Builders and the U.S. Census Bureau, the markets for home remodeling and new home sales are picking up and are showing significant improvement from the numbers we saw during the financial crisis. For example, single family new home sales increased by 25% since February 2014. Hence, Headwaters benefits from this growth in the housing markets with its products and services. As a matter of fact, the sale of its coal combustion products and its light building products give the company a competitive advantage versus its competitors. Also, HW uses fly ash as a substitute to concrete because it is considered more resistant than traditional concrete and less susceptible to water infiltration. In the company's 10K we can clearly see that in 2012 the firm used approximately 20% of its fly ash instead of traditional concrete in US products. HW is confident that its fly ash will receive increasing demand in the upcoming years because the US Environmental Protection Agency ruled fly ash as not hazardous and environmentally friendly. Thus, home constructors will favor houses made with fly ash than traditional cement.

Another promising factor that Headwaters could look at is the growth rate in the remodeling industry. As a matter of fact, in the past four years the US market has witnessed a high level of remodeling activity of houses during 2015. According to the National Association of Home Builders, "every metropolitan statistical area in the United States can look forward to increasing remodeling activity this year, with growth averaging 4% and the nation as a whole set to reach an unprecedented level of activity by the third quarter"[1]. This view is confirmed by the graph below as it shows Residential Remodeling Index is increasing since 2012.

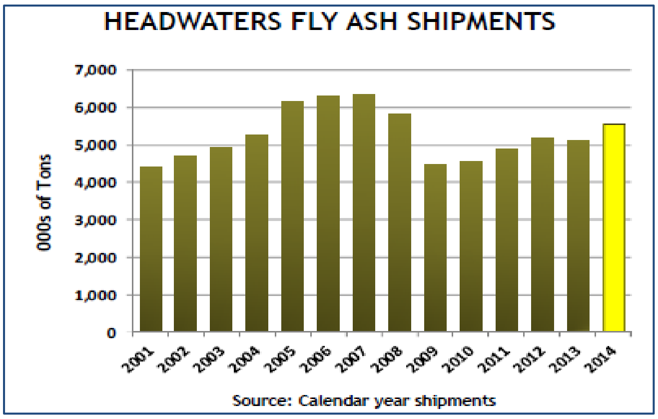


The demand for remodeling items, such as decorative window and door trim, will increase in the upcoming years and Headwaters' light building products will benefit from this improvement. Thus, HW works closely with retailers like Home Depot in order to increase its chances of selling remodeling items for home remodelers and to position itself in a market that is expected to grow.

[1] http://www.remodeling.hw.net/benchmarks/economic-outlook-rri/

Leading position in the concrete market

Headwaters has the leading position in the supply of fly ash, a product that enhances the durability of concrete. This product is made by burning coal at power plants and other coal combustion products without the need for virgin new materials. This product is interesting because it reduces CO2 emissions and energy consumption with greater long-term strength for infrastructure projects such as: roads, bridges, and highways. Fly ash can easily replace the traditional cement because it is generally less expensive.

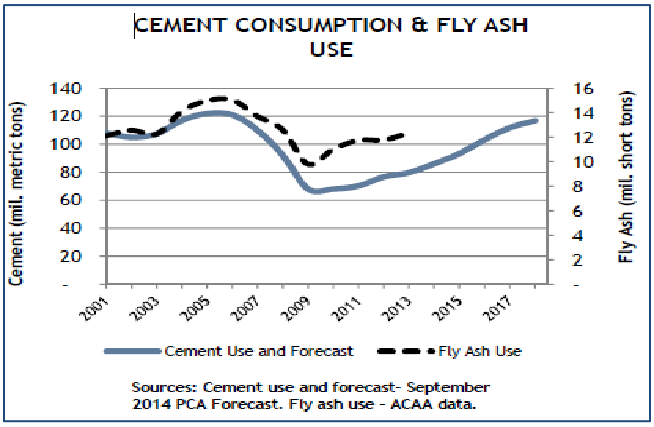


According to the American Road and Transportation Builders Association report, "the cost to build roads, runways and bridges would increase by an estimated $104.6 billion over the next twenty years if fly ash were not available[2]." Thus, Headwaters' business model will benefit from reports that underline the importance of fly ash as it has positive environmental impacts. In fact, it reduces landfill utilization and several positive impacts:

Impacts of CCP Beneficial Use
(Approximate Annual Reductions)

Ash landfilling	51 million tons
CO_2 emissions	12 million tons
Water use	30 billion gallons
Federal/State spending ..	+$5 billion

The recent acquisition in July 2014 of LA Ash Products and Services will strengthen Headwaters' ability to meet customer needs in Louisiana and Texas region. Thus, this cash purchase will increase fly ash sales by more than 300,000 tons. Headwaters has a competitive advantage because it established exclusive long term contracts with nearly 100 power plants in 35 states and developed nationwide infrastructure with 25 fly ash terminals, 100 trucks and 850 railcars. The firm expects that the growth in cement consumption drives fly ash demand and this will create a long term customer relationship.



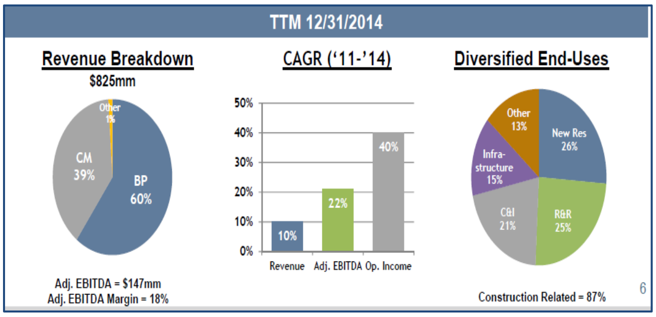
This assumption is based on several reports that cement demand will exceed capacity by 2016 and a 20 million ton shortfall is expected. HW will tackle this gap with a stable fly ash supply thanks to its larger and newer power plants.

Diversified end markets

Headwaters is ranked number one in U.S. market share for its Light Building Products and number one in manufactured stone veneer. Thanks to these two product lines, the firm can achieve high growth in key areas of the construction materials market. The company has also been able to achieve number one market share in the Texas concrete block market for commercial and institutional construction. The Light Building Products segment gives HW the ability to produce environmentally and sustainable wall components that reduces waste, protects natural resources, and uses less energy in either the manufacturing process or application. Throughout its Light Building Products brands, Headwaters is a market leader in the manufacturing of building products and professional tools used in residential remodeling and construction. Hence, wholesalers and big box retailers choose Headwaters because its brands, such as Kleer Lumber,

[2] http://www.acaa-usa.org/Portals/9/Files/PDFs/Ash_at_Work_final_LR.pdf

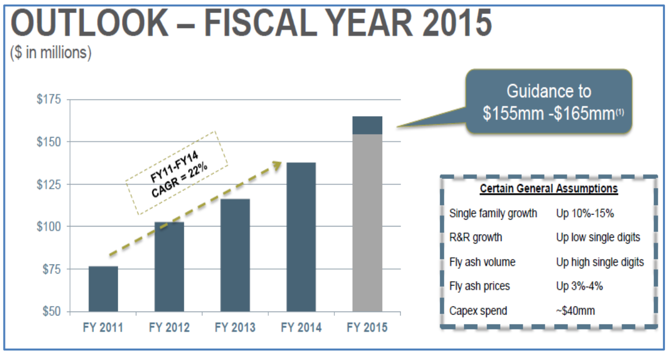
Atlantic Premium Shutters and Tapco Tools Systems, always achieve customer satisfaction. The company also tries to manufacture and market premium quality architectural stone veneer with brand names like: Eldorado Stone and Dutch Quality Stone. Overall, Headwaters deliver products that are more sustainable combining both fly ash and cement in order to create products both at lower cost and improved quality. This diversification will give Headwaters the ability to increase its revenue, adjusted EBITDA and operating income in the long term.



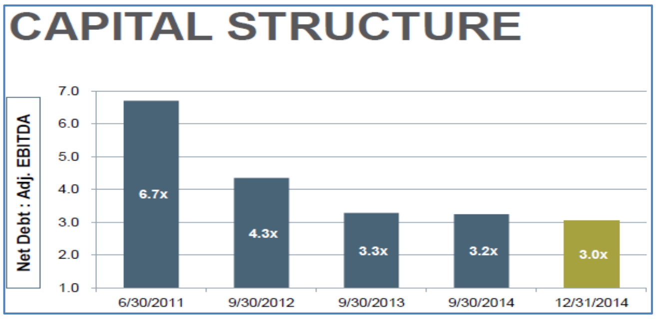
Debt Reduction and financial results

Over the past few years Headwaters has been able to significantly reduce debt levels. At the end of the June 2011 quarter the firm's net debt to adjusted EBITDA ratio was 6.7x. At the end of the fiscal 2014-year, Headwaters' net debt to adjusted EBITDA ratio was 3.2x. The company continues to focus on the appropriate use of debt to enhance shareholder returns, but remains determined to reduce its overall leverage to a range of 2.5x to 3.0x net debt to Adjusted EBITDA.

The company's total revenue for the fiscal year 2014 was $791.4 million, which is up 13% from fiscal year 2013. Gross profit increased 17% from $192.5 million in 2013 to $225.7 million in 2014 and operating income went from $54.4 million in 2013 to $66.7 million in 2014, which is an increase of 23%. Adjusted income from continuing operations was $52.5 million compared to $38.7 million in 2013, representing increases of 36%. Net income including discontinued operations increased from $7.1 million in 2013 to $16.1 million in 2014. We can clearly see the growth in Q1 of 2015. In fact, the firm posted an increase in EBITDA of 39% with a 21% increase in revenue compared to 2014 levels. During the earnings call, the management team decided to give EBITDA guidance for 2015 between $155 and $165 million.



Also, the CFO outlined the commitment of the company to reduce its debt levels. According to the CFO, the company will refinance $400 million of notes originally due April 2019 by extending the maturity dates and reducing interest costs. Thus, Headwaters wants to reduce unnecessary debt from its balance sheet in order to preserve its promising growth with its cash of approximately $152 million. As you can see on the chart below, HW is continuing to reduce its leverage ratio that went from 6.7x to 3.0x ending Q1 2015.



Conclusion

Following the strong Q1 2015 figures, investors can expect a positive Q2 with healthy numbers. Headwaters still has to reach its full potential and is positioned to continue its recent growth. Hence, Headwaters seems an attractive investment that should be considered for the long term play.

The only main risk that Headwaters could face is a decrease in home construction and remodelling. In fact, the building and remodelling activity was low between 2007 and 2011 and the firm is afraid to experience reduced margins as well as goodwill impairments. Headwaters hopes that the trend will continue or even stay flat at a comfortable level in order to remain profitable and realize a good return for investors.

The company offers a broad range of products with important market share and a broad distribution system for their products. The management team has also played an important role because they have been able to grow the company through strategic acquisitions and achieve organic growth with interesting products.

Forecasts

After analyzing the business model of Headwaters and the potential it can bring in the long term, several assumptions in the proforma were put in place. For example, HW achieved a growth of 12.6% in 2014 and after listening to the earning call of the management team they seem confident to attain a growth of at least 11% for 2015. In fact, the management team believes that HW has the patent products that will attract new customers looking for fly ash instead of traditional cement. In the proforma, their long term growth will end up at 4% as new competitors will emerge and compete with Headwaters. The operating costs will be between 82% and 75% since HW is looking to reduce its costs by reorganizing its distribution system. The long term ROIC exceeds the WACC since the company generates positive cash flow relative to the capital it has invested in its business. The Monte-Carlo simulation has been run and it pops up a 1 year target of $21.73 with an intrinsic value of $19.81. Overall, the proforma shows the potential that the company can create with its unique products.

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Headwaters Incorporated	HW	Analyst	Current Price	Intrinsic Value	Target Value	Divident Yield	Target Return	NEUTRAL
		DJ SAM	$18.31	$18.84	$20.97	0%	1-y Return: 14.51%	

General Info

Sector	Materials
Industry	Construction Materials
Last Guidance	Mar-24-2015
Next earnings date	5/4/2015

Market Data

Enterprise value	$1,789.85
Market Capitalization	$2,032.29
Daily volume	0.25
Shares outstanding	73.70
Diluted shares outstanding	75.02
% shares held by institutions	99.58%
% shares held by insiders	2.81%
Short interest	2.42%
Days to cover short interest	2.53
52 week high	$19.14
52-week low	$10.27
5y Beta	2.54
6-month volatility	32.56%

Peers

Peers	Market Cap.
Texas Industries Inc.	
Eagle Materials Inc.	$4,225.28
James Hardie Industries plc	$6,983.82
USG Corporation	$3,781.36
Cementos Molins, S.A.	$592.10
Vulcan Materials Company	$10,843.93
Covanta Holding Corporation	$2,914.51
Toyo Asano Foundation Co.,Ltd.	$2,877.90
Asahi Concrete Works Co., Ltd.	$8,362.07
CSR Limited	$1,927.86

Current Capital Structure

Total debt/market cap	45.13%
Cost of Borrowing	7.10%
Interest Coverage	1.3x
Altman Z	1.30
Debt Rating	C
Levered Beta	0.98
WACC (based on market value weights)	7.25%

Management

Professional	Title	Comp. FY2012	Comp. FY2013	Comp. FY2014
Benson, Kirk	Chairman and Chief Executive Offi	$3,701,360	$3,680,809	$9,317,594
Newman, Donald	Chief Financial Officer	$900,479	$1,309,897	$1,751,835
Hatfield, Harlan	Vice President, General Counsel ar	$930,425	$889,588	$1,233,379
Lents, Murphy	President of Headwaters Siding an	$952,104	$602,883	$844,439
Gehrmann, William	President of Headwaters Heavy Cc	$1,315,835	$1,470,298	$722,226
Madden, Sharon	Vice President of Investor Relatior	$0	$0	$0

Historical Median Performance

	HW	Peers	Industry	All U.S. firms
Growth	1.4%	1.8%	3.4%	7.4%
ROIC	7.1%	4.0%	7.4%	14.3%
NOPLAT Margin	6.8%	5.6%	6.3%	10.4%
Revenue/Invested Capital	1.04	0.71	1.17	1.37
Excess Cash/Rev.	8.5%	10.9%	13.5%	12.9%
Total Cash /Rev.	8.5%	10.9%	12.3%	15.2%
Unlevered Beta	0.93	0.83	1.01	0.95
TEV/REV	1.3x	2.0x	2.8x	2.5x
TEV/EBITA	12.6x	36.2x	18.4x	13.1x
PE (normalized and diluted EPS)	18.7x	32.8x	41.4x	23.5x
P/BV	1.0x	2.5x	3.1x	2.2x

Past Earning Surprises

	Revenue	EBITDA	Norm. EPS
Last Quarter	5.8%	16.0%	100.0%
Last Quarter-1	1.2%	4.8%	0.0%
Last Quarter -2	-0.2%	-0.4%	-36.4%
Last Quarter -3	4.0%	17.3%	NM
Last Quarter -4	3.8%	9.1%	NM

Non-GAAP Adjustments in estimates computations

Operating Leases Capitalization	0%	N/A	N/A
R&D Exp. Capitalization	100%	Straightline	10 years
Expl./Drilling Exp. Capitalization	0%	N/A	N/A
SG&A Capitalization	0%	N/A	N/A

Proforma Assumptions

Money market rate as of today	0.54%
Annual increase (decrease) in interest rates	0.1%
Yield Spread accelaration	1.2
Marginal Tax Rate	37.5%
Risk-Free rate	2.6%
Tobin's Q	0.80
Op. Cash/Rev.	7%
Growth in PPE	NPPE Growth follows Revenue Growth
Long term Growth	4.0%
Base Year Unlevered Beta	is equal to 0.83
Long term Unlevered Beta	0.83

Forecast

Period	Rev. Growth	Adj. Op. Cost/Rev	Invested Capital	NOPLAT Margin	ROIC	WACC
LTM	12.6%	82.7%	$628.81	8%	11.0%	7.2%
NTM	11.8%	81.9%	$663.01	10%	14.9%	7.3%
NTM+1	11.5%	81.2%	$694.05	10%	16.2%	7.4%
NTM+2	11.0%	80.4%	$726.14	11%	17.8%	7.5%
NTM+3	10.1%	79.6%	$758.62	11%	19.5%	7.6%
NTM+4	9.3%	78.8%	$791.08	12%	21.3%	7.6%
NTM+5	8.4%	78.1%	$823.08	12%	23.0%	7.7%
NTM+6	7.5%	77.3%	$854.17	13%	24.7%	7.8%
NTM+7	6.7%	76.5%	$883.84	13%	26.4%	7.9%
NTM+8	5.8%	75.8%	$911.58	14%	27.9%	8.0%
Continuing Period	4.9%	75.0%	$721.23	12%	14.0%	8.1%

Valuation

Period	Invested Capital x (ROIC-WACC)	Total Debt	Other non-interest bearing claims	Shares Outstanding
LTM	$0.00	$599.62	-$32.86	73.70
NTM	$47.37	$599.62	-$46.46	73.70
NTM+1	$58.14	$599.62	-$74.75	73.70
NTM+2	$71.68	$599.62	-$117.00	73.70
NTM+3	$86.92	$599.62	-$175.40	73.70
NTM+4	$103.52	$599.62	-$251.69	73.70
NTM+5	$121.12	$599.62	-$385.07	73.70
NTM+6	$139.38	$599.62	-$501.73	73.70
NTM+7	$157.91	$599.62	-$640.77	73.70
NTM+8	$176.34	$599.62	-$802.98	73.70
Continuing Value	$1,268.26			

Pricing Model

Period	DCF (Weight = 100%)	Relative (Weight = 0%)	Distress (Weight = 0%)	Weighted Average Price Per Share
LTM	$19.80	$19.41	$19.87	$19.80
NTM	$21.72	$27.75	$21.85	$21.72
NTM+1	$23.24	$32.21	$23.39	$23.24
NTM+2	$24.92	$37.02	$25.04	$24.92
NTM+3	$26.69	$42.12	$26.78	$26.69
NTM+4	$28.74	$47.48	$28.58	$28.74
NTM+5	$30.88	$53.56	$30.90	$30.88
NTM+6	$32.77	$59.27	$32.77	$32.77
NTM+7	$34.66	$65.06	$34.52	$34.66
NTM+8	$35.98	$70.87	$36.20	$35.98

Monte Carlo Simulation Assumptions

	Base	Stdev	Min	Max	Distribution
Revenue Variation	0	10%	N/A	N/A	Normal
Op. Costs Variation	0	10%	N/A	N/A	Normal
Country Risk Premium	6%	N/A	5%	7%	Triangular
Long term Growth	4%	N/A	1%	7%	Triangular

Monte Carlo Simulation Results

	Intrinsic Value	1y-Target
Mean est.	$19.80	$21.72
σ(ε)	$0.32	$0.25
3 σ(ε) adjusted price	$18.84	$20.97
Current Price	$18.31	
Analysts' median est.		$17.92