

Investigation Report Fletcher Building Limited - Continuous Disclosure



Executive Summary

PURPOSE OF THIS REPORT

This report sets out NZX Regulation's findings following our investigations into whether NZX Main Board Listing Rule (Rule) 10.1.1 was breached by Fletcher Building Limited (FBU or, together with its consolidated subsidiaries, the Group).

This report also:

- ▶ Provides an overview of our investigation process; and
- ▶ Includes observations on practices relating to continuous disclosure, given previous guidance published by us.

SUMMARY OF FINDINGS

In March 2017, FBU materially downgraded the forecast earnings guidance it had most recently confirmed in February 2017. This downgrade had a material effect on the price of FBU shares. We investigated when FBU became aware of the need to downgrade the forecasts, to determine whether FBU had complied with its continuous disclosure obligations.

During the course of that investigation, in July 2017, FBU further downgraded the revised forecasts it had published in March. This announcement also had a significant impact on the price of FBU shares. We widened the scope of our investigation to include this subsequent downgrade.

Issuers are required to disclose Material Information immediately, subject to certain exceptions. Our investigation focussed on what information was in the possession of FBU's executive officers and

directors, and the timing of FBU's disclosure to the market.

Based on the information obtained during our investigations, NZX Regulation has determined that FBU did not breach its continuous disclosure obligations in relation to the forecast earnings downgrades. In particular, we have concluded that FBU released the Material Information relating to FBU's earnings forecast downgrades in March and July 2017 promptly and without delay, as required under the Rules. This included information on the actual changes to those forecasts, and the existence of the material risk of the material deviation from FBU's previously announced earnings forecasts.

This report includes a reminder to Issuers of some key matters we have previously published guidance on. In particular, Issuers should ensure they have robust internal oversight and escalation processes. Those processes are critical to ensuring that material operating and financial issues are identified and appropriately escalated to executive officers and directors, and therefore that Material Information is announced in a timely manner. A perceived failure to appropriately manage the operational aspects of disclosure can have reputational impacts for an Issuer, particularly if there is a perception that an Issuer has delayed the disclosure of Material Information to the market.

January - 2018



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Scope of Investigation

OBLIGATIONS AS A LISTED ISSUER

Issuers listed on the NZX Main Board are subject to continuous disclosure obligations. Those obligations are set out in Rule 10.1.1. That Rule requires that once an Issuer is aware of Material Information, it must immediately release that information to the market. This over-arching disclosure obligation is subject to certain prescribed exceptions.¹

We have published guidance to assist Issuers to understand and comply with their continuous disclosure obligations. This includes the [NZX Continuous Disclosure Guidance Note \(Guidance Note\)](#).

When investigating compliance with this Rule, we seek to determine:

- ▶ What information is Material Information in respect of that Issuer;
- ▶ If so, when the Issuer became aware of that Material Information;
- ▶ Whether that Material Information was released “immediately”; and
- ▶ If not, whether the Material Information was subject to an exception from disclosure.

Material Information is defined by the Rules as information that a reasonable person would expect, if it were generally available to the market, to have a material effect on the price of the Issuer’s securities. The information must relate to the Issuer’s shares, or the Issuer itself, rather than to securities generally or Issuers generally.

The footnote to Rule 10.1.1 states that information concerning a change in an Issuer’s financial forecast or expectation is likely to be Material Information. In addition, the Guidance Note states: “it is important that all Issuers regularly assess their financial performance against any announced financial projections, forecasts or expectations and keep the market fully informed of any matters that are material to their progress in achieving them. We expect an Issuer to immediately disclose where the Issuer believes that, based on one or more of its regular assessments, there is a material risk that the actual results of the Issuer will materially differ from an announced projection, forecast or expectation.” This disclosure is usually made in the form of an updated forecast.

ANNOUNCEMENTS TO WHICH THIS INVESTIGATION RELATES

FBU has a 30 June balance date. The relevant financial year was 1 July 2016 to 30 June 2017 (FY17).

On 22 February 2017, FBU released its half year financial results. That announcement confirmed guidance it had previously given to the market, that operating earnings² were expected to be in the range of \$720 to \$760 million for FY17.

We received an urgent trading halt application from FBU on Friday, 17 March 2017. That application stated that FBU was reviewing the financial performance of its Construction division and its impact on earnings guidance previously provided to the market. The halt was applied at 10.00am.

On Monday, 20 March 2017, FBU published its announcement "FBU Updated FY2017 Earnings Guidance". That announcement included details of a downgrade in forecast earnings for FY17 from a

¹ As set out in Rule 10.1.1(a)(i) to (iii).

² Operating earnings before interest, tax and significant items

range of \$720 - \$760 million, to a revised range of \$610 - \$650 million. The trading halt in FBU was lifted following the release of the announcement. FBU's share price declined 13% from an opening price of \$9.22 on 20 March 2017 to an intra-day low of \$8.00. It closed at \$8.28, on higher than average trading volumes.

On 20 July 2017, FBU published its announcement "FBU FY17 Trading Update and Departure of CEO". That announcement included details of a further downgrade in forecast earnings for FY17, to \$525 million. FBU's share price declined 8.8% from an opening price of \$8.09 on 20 July 2017 to an intra-day low of \$7.38. It closed at \$7.59, again on higher than average trading volumes. Our investigations related to the information disclosed in the March and July announcements.

WHEN DOES NZX REGULATION INVESTIGATE?

We have published [Our Approach to Enforcement](#), which sets out information about our approach to investigating and enforcing NZX's market rules.

We investigate conduct that indicates a possible breach of NZX's market rules. To best utilise our resources, we have identified the following enforcement priorities:

- ▶ Issues which have a significant market impact – for example, investor loss or impact to the wider market;
- ▶ Continuous disclosure and periodic reporting issues;
- ▶ Corporate governance issues; and
- ▶ Responding to market developments.

We also have a particular interest in changes in Issuers' forecasts, and in announcements which result in movements of more than 5% in an Issuer's share price and/or which result in significant trading volumes. In the case of FBU, we also noted:

- ▶ the proximity of the March earnings downgrade to the half year results announcement released in February, when previous forecast earnings guidance had been confirmed; and
- ▶ the proximity of the subsequent July earnings downgrade to the March earnings downgrade.

FOCUS OF INVESTIGATION

Our investigation of FBU focused on determining:

- ▶ What information relating to FBU earnings was Material Information;
- ▶ When directors or executive officers of FBU had possession of that information, such that FBU was aware of it for the purpose of the Rules;
- ▶ When FBU was required to disclose the information, and whether it met that obligation; and
- ▶ If the information was not released immediately, whether that information was subject to an exception from the obligation to disclose.

Market rumour and speculation about FBU's financial and operating performance was also noted during the relevant period. We considered whether such market rumours and speculation may have triggered FBU's continuous disclosure obligations.

INFORMATION OBTAINED DURING INVESTIGATION

We obtained and considered a wide range of information in our investigation. This included:

- ▶ Information that we requested from FBU such as Board papers, management reports, minutes, and responses to our questions;
- ▶ Information provided by FBU executive officers at meetings with our staff;
- ▶ Historical data relating to FBU's disclosure;
- ▶ FBU trading data; and
- ▶ Information that was in the public domain (e.g. media reports).

Findings

WHAT WAS MATERIAL INFORMATION?

The test of what is Material Information is Issuer-specific. The question of what information a reasonable person would expect to have a material effect on the price of an Issuer's securities is influenced by a number of factors, including the scope of information already available to the market.

It is the primary responsibility of Issuers to make an assessment of whether information is Material Information, and subject to immediate disclosure under the Rules.

Our investigation of FBU sought to determine whether information relating to:

- ▶ The actual changes to FBU's earnings forecasts;
- ▶ The material risk of a material deviation from FBU's earnings forecasts;
- ▶ Losses on specific FBU projects; and/or
- ▶ Public rumours and speculation regarding FBU's financial and operating performance,

was Material Information for FBU.

Actual changes to FBU earnings forecasts

We consider that:

- ▶ FBU's earnings forecast downgrade, announced in March 2017; and
- ▶ FBU's subsequent earnings forecast downgrade, announced in July 2017,

was Material Information.

In particular, we note that:

- ▶ The March 2017 earnings forecast downgrade was \$110 million, or approximately 15% down on the forecast range confirmed in February 2017; and
- ▶ The July 2017 earnings forecast downgrade was between \$85 million and \$125 million down on the revised March 2017 forecast range, or between 14% and 19%.

These changes in earnings forecasts were material. For the purposes of the Rules, we consider that a reasonable person would expect information about the material changes in these forecasts to have a material effect on the price of FBU's shares, if that information was generally available. Accordingly, we consider the changes in FBU's earnings forecasts were Material Information for FBU.

Material risk of material deviation

The Guidance Note states that a material risk that actual results will materially differ from an announced projection, forecast or expectation is likely to be Material Information. That material risk of a deviation will usually arise before the actual change in the forecast is confirmed. It is the material risk of a future material deviation that is the Material Information, in these circumstances.

We consider that a material risk of a forecast earnings downgrade of the size announced by FBU in March and July would be Material Information. It is important to note that the time at which such a material risk

of a material deviation is known, and the time at which the actual change in forecast is itself confirmed, may be so close that separate immediate disclosure is impractical or impossible.

We have considered when the material risk of the changes in FBU's earnings forecasts crystallised. This is essentially a question of timing, and is discussed further below, in the section *When was FBU aware of the Material Information?*

Losses on specific FBU projects

FBU's earnings forecast downgrades reflected losses being accrued in a number of projects within the FBU Building and Interiors business unit (**B+I unit**).

We consider that information about those specific losses was not separately Material Information for FBU. This recognises the specific facts and circumstances relevant to FBU and how market expectations of its financial performance were set, which will necessarily differ from issuer to issuer. Market expectations of FBU's financial performance were set by the published Group level earnings forecasts. In these circumstances, we consider that financial performance at a business division level would need to be assessed in relation to how the performance impacted the Group earnings forecasts in order for that information to be Material Information for FBU.

Rumours and speculation

Starting at the time of the March 2017 downgrade, a number of New Zealand media outlets published articles alleging that people within the building and construction industry were aware of issues with the performance of certain projects in the B+I unit, and losses arising from those projects, prior to the downgrade.

We specifically considered whether this rumour and speculation may have been information that was subject to FBU's continuous disclosure obligations. This included assessing the nature of the information alleged and FBU's responses to those allegations, together with other information provided to us as part of our investigations. We also considered that rumour and speculation in the context of considering when FBU's executives and directors may have become aware of sufficiently specific significant information in relation to the possible losses on specific projects in the B+I unit.

Our investigation is limited to assessing compliance with the Rules. It is noted that:

- ▶ Rumours relating to progress on the status of particular FBU projects are not the same as rumours about FBU's financial performance at a Group level;
- ▶ Rumours about financial performance measures must have a sufficient degree of credibility, specificity and certainty, in order to give rise to potential disclosure obligations; and
- ▶ In any case, in order for FBU to have a disclosure obligation the information must be in the possession of FBU's executive officers or directors. We have not identified any evidence that executive officers or directors of FBU were in possession of Material Information as a result of the rumours and speculation relating to its progress on particular projects.

WHEN WAS FBU AWARE OF THE MATERIAL INFORMATION?

The obligation to disclose information under Rule 10.1.1 is effectively limited to Material Information that is in the possession of an executive officer or a director.

Our investigation sought to establish when FBU's executive officers and directors were in possession of the relevant Material Information, and the processes implemented by FBU once that information was in

the possession of FBU's executive officers and directors. This reflects the scope of the obligation under Rule 10.1.1, which does not impose disclosure or process obligations on information in the possession of other general personnel.

Changes to forecast financial performance can:

- ▶ Develop over time, as information becomes available to the executive officers and the directors incrementally; or
- ▶ Crystallise suddenly as a response to particular events or information.

The FBU Board receives regular updates on each of its five divisions, and detailed strategic presentations on each division and on business units within each division on a rolling basis. In addition, FBU undertakes monthly operational reviews of its business units.

In late 2016, as a result of one of these reviews, a number of matters relating to the Construction division were brought to the attention of the FBU Board. That review focused on issues relating to personnel, organisational structure, and management and governance processes within the Construction division.

Those issues led to a strategic review of the Construction division, including the B+I unit. During the strategic review, the performance of the B+I unit and specific projects within that business unit became an increasing focus for senior FBU executive officers and the FBU Board. This included an in depth project-by-project review of the Construction division, and changes to the senior leadership team and senior management functions within the Construction division.

As a result of this process, FBU senior executives became aware of information relating to the financial performance of the B+I unit, and the impact of certain major projects on that performance. Determining margins on construction projects is complex, requiring subjective assessments and prudent judgements to be made on future events. These assessments need rigorous testing by management to ensure appropriate judgements are made. Due to financial reporting standards that apply to construction projects, any projected losses must be immediately accounted for. FBU tracked these projects and the estimated impact of projected losses on the FBU Group earnings forecast.

Although losses were being recognised for certain projects in the B+I unit during late 2016 and early 2017, these did not initially have a material impact on the Group earnings forecast, which remained within the published guidance range. As the review continued throughout the first quarter of 2017, additional information and estimates relating to the financial performance of the Construction division became available to executive officers.

We have observed that events will often accelerate rapidly when a potential issue relating to financial performance is identified. For example, it is not unusual to see a pattern of intra-day meetings that lead to internal escalation over a day or several days. We observed this during FBU's earnings forecast downgrades, with several key meetings and decision points occurring in the space of a single day and into the evening. This aligns with our expectation that issuers will proactively manage such issues as they arise, and not defer or delay escalation or monitoring of when a continuous disclosure obligation may have been triggered.

Our investigation identified that FBU acted promptly when information relevant to FBU's financial performance and earnings forecasts came into the possession of executive officers and directors. This included FBU assessing that information in light of FBU's continuous disclosure obligations.

Following our investigation, we determined that, for the purposes of the Rules:

- ▶ March 2017 downgrade: FBU first became aware on the evening of 16 March 2017 that there was a material risk that its actual Group earnings results would materially differ from its published forecast. That awareness arose when information was provided to FBU executive officers that evening on additional projected losses on a key Construction division project. In order to manage its disclosure obligations, and in accordance with NZX Regulation guidance, FBU applied for a trading halt while it sought further information to confirm its revised forecast. This included assessing information relating to provisions against future losses. The actual change to FBU’s earnings forecast was confirmed while the trading halt was in place. FBU released its announcement on the earnings forecast downgrade before market open on 20 March 2017, at which time the trading halt was lifted; and
- ▶ July 2017 downgrade: FBU first became aware on the evening of 19 July 2017 that there was a material risk that its actual Group earnings results would materially differ from the revised earnings forecasts that had been published on 20 March 2017. That awareness arose when information was provided to FBU executive officers as a result of regular project reviews, regarding projected losses in various of those projects. Following engagement with management and FBU’s auditors, the FBU Board determined that additional loss provisioning would also be required. FBU released its announcement on this subsequent earnings forecast downgrade before market open on 20 July 2017.

TIMING OF FBU’S DISCLOSURE

The Guidance Note explains that “immediately” means “promptly and without delay”.

We have concluded that the Material Information relating to FBU’s earnings forecast downgrades in March and July 2017 was released promptly and without delay by FBU.

In relation to the March 2017 downgrade:

- ▶ FBU received information relating to the performance of the B+I unit over a period of time. It tracked this information, and sought additional information, on an ongoing basis;
- ▶ FBU executive officers and Board actively monitored FBU’s disclosure obligations. This culminated in Material Information coming into the possession of FBU executive officers on the evening of Thursday 16 March 2017, that there was a material risk that the FBU Group earnings results would materially differ from its published earnings forecast;
- ▶ FBU sought a trading halt in order to assist it to manage its disclosure obligations in relation to the evolving risk of a material deviation from its forecasts. The timing and duration of this halt were appropriate; and
- ▶ FBU disclosed the Material Information “promptly and without delay” on Monday 20 March 2017.

In relation to the July 2017 downgrade:

- ▶ FBU continued to give particular attention to the performance of the B+I unit, and the progress of projects within that business unit, following the March 2017 downgrade;
- ▶ Events accelerated in July 2017, and the FBU executive officers and Board continuously monitored FBU’s disclosure obligations through this period. This culminated in Material Information coming into the possession of FBU executive officers and the FBU Board on the evening of 19 July 2017, that there was a material risk that the FBU Group earnings results would materially differ from its revised earnings forecast; and
- ▶ FBU disclosed the Material Information “promptly and without delay” on 20 July 2017.

WHETHER EXCEPTIONS TO DISCLOSURE APPLIED

We also considered whether there were any circumstances in which FBU may have sought to rely on an exception to immediate disclosure.

We note that FBU did not purport to rely on such exceptions, and due to the nature of the events and the order in which they arose, the exceptions were not relevant to a consideration of FBU's compliance with its continuous disclosure obligations.

Other comments

In addition to the Guidance Note, we:

- ▶ Have published Practice Notes relating to disclosure and trading halts;
- ▶ Have published a Thematic Review on issuer disclosure practices; and
- ▶ Provide one-on-one guidance and support to issuers as part of our market oversight and engagement activities.

Although we have concluded that the FBU earnings forecast downgrades did not breach the Rules, this case does highlight a number of matters covered by our previous guidance.

ASSESSING COMMERCIAL INFORMATION

We have no mandate to determine the reasonableness of Issuers' commercial judgment or decision making. We do, however, have an interest in Issuers' processes for identifying operational and financial issues. Those processes are relevant to how Issuers escalate information internally, and provide timely disclosure to the market. We have previously stated that we will view delays in information being escalated to directors or executive officers as an aggravating factor, when assessing the seriousness of a breach of continuous disclosure obligations.

We remind Issuers that they should have systems and processes in place to:

- ▶ Identify significant risks within the business, and where Material Information may arise within the business; and
- ▶ Enable issues to be effectively escalated for consideration by executive officers and/or directors. This may include a whistle-blower policy. It should be clear that communication is to be made on an urgent basis.

There has been significant public discussion regarding FBU's commercial judgment in respect of the Construction division and whether issues were appropriately escalated within the business. We have also previously observed this kind of speculation in respect of disclosures by other Issuers. Information provided by FBU indicates that it was cognisant of ensuring timely escalation within the business and has processes in place to address this including within the Construction division.

IMPORTANCE OF COMPLIANCE PROCEDURES

A continuous disclosure obligation is triggered as soon as Material Information is within the possession of an executive officer or director. This requires Issuers to have:

- ▶ Robust procedures for assessing information provided to executive officers and directors, to determine whether or not this is Material Information; and
- ▶ A clear allocation of responsibility within the business, to ensure accurate and timely dissemination of information internally, and prompt public disclosure.

In this case, FBU's executive officers quickly escalated information within their possession to the Board. FBU had processes in place to track developing information relating to the Group financial results, and

to assess the impact of new information as it became available. Board papers and minutes clearly documented agenda items relating to continuous disclosure, which we recommend as best practice.

Issuers must be able to respond quickly to Material Information that develops. This may include, as was the case for FBU, convening multiple Board meetings on short notice, calling executives back from leave and engaging with advisors outside of business hours. An ability to respond with urgency will reduce the risk that disclosure cannot be made "promptly and without delay". Issuers' executive officers and directors must be on notice that they could be required to consider these sorts of issues with little prior warning.

Appendix One

Rule 10.1.1(a)

Without limiting any other Rule, every Issuer shall:

- (a) once it becomes aware of any Material Information concerning it, immediately release that Material Information to NZX, provided that this Rule shall not apply when:
 - i. a reasonable person would not expect the information to be disclosed; and
 - ii. the information is confidential and its confidentiality is maintained; and
 - iii. one or more of the following applies:
 - a. the release of information would be a breach of law; or
 - b. the information concerns an incomplete proposal or negotiation; or
 - c. the information comprises matters of supposition or is insufficiently definite to warrant disclosure;
or
 - d. the information is generated for the internal management purposes of the Issuer; or
 - e. the information is a trade secret.

In this Rule 10.1.1, an Issuer is aware of information if a Director or an executive officer of the Issuer (and in the case of a Managed Investment Scheme, a Director or executive officer of the Manager) has come into possession of the information in the course of the performance of his or her duties as a Director or executive officer.

ABOUT NZX REGULATION

Issuers that are listed on NZX's markets must comply with the NZX Listing Rules. In this case the relevant rules are the Main Board Listing Rules (**Rules**). Among its other functions, NZX Regulation (**NZX Regulation**) is responsible for monitoring compliance with the Rules, investigating potential breaches, and taking appropriate enforcement action where required.

NZX Regulation also publishes guidance, and undertakes market engagement, to assist Issuers to meet their obligations.

To find out more about what NZX Regulation does, including information on its investigation and enforcement functions, please refer to the [NZX Oversight and Engagement report](#).





Centre

CABLE STREET



NZX Limited

Level 1 / NZX Centre

11 Cable Street

PO Box 2959

WELLINGTON

Tel: +64 4 472 7599

info@nzx.com

www.nzxgroup.com