2023 Construction Materials Market Outlook

February 2023

EXECUTIVE SUMMARY:

The 2022 operating year for construction materials (CM) truly began in November 2021 with the passage of the once-in-a-generation $1.2 trillion Infrastructure Investment and Jobs Act (IIJA), prompting euphoria among CM firms that stood to benefit from public works through 2026. Then economic headwinds hit.

In February 2022, inflation scaled to a 40-year high, and uncertainty began to spread. Driven by an overstimulated economy and geopolitical tensions, the Federal Reserve began a course of tightening. Throughout the year the Fed aimed for fiscal policy that would result in a "soft landing." This mentality continued into 2023, with efforts to avoid sending the economy into a recession — the results remain to be seen.

For all the upheaval, CM firms remained resilient with the headline of "demand is strong" resonating through the sector. Much of the industry was able to counteract inflation through price increases, allowing earnings to remain consistent. As we look ahead to 2023, the threat of a recession still looms; but there are reasons to be optimistic for construction materials. IIJA funding and projects are coming online, providing opportunities to withstand a potential bear market. As single-family residential has slowed, demand for CM products has shifted to other end markets such as multifamily and commercial and industrial projects. Time will tell, but ultimately CM performance in 2023 hinges on five key elements:

Figure 1: Five Key Elements to Watch in 2023

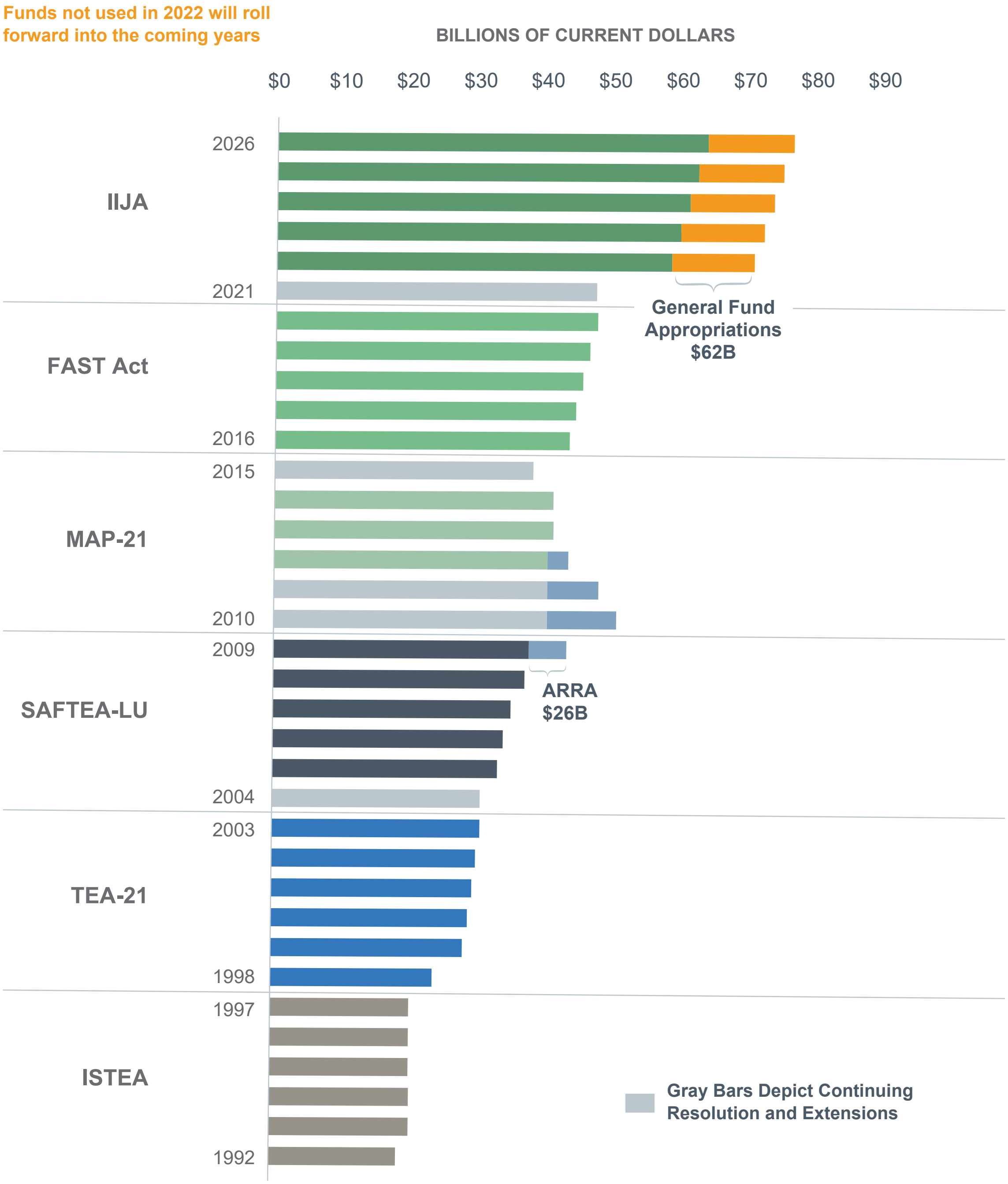
1. Reccession and Consumer Confidence
2. Inflation and Interest Rates
3. IIJA Rollout
4. Demand and Backlogs
5. Global Events — War, COVID, etc.

From a mergers and acquisitions (M&A) perspective, 2022 didn't quite match the highs of 2021, which were fueled in part by cheap borrowing costs, abnormally large cash balances and pent-up demand from the pandemic. Still, it was a successful year for bolt-on acquisitions and several well-aligned, large strategic transactions. For 2023, M&A success hinges on the strength of backlogs, firms' ability to maintain margins amid inflationary pressures, and the dynamics of specific geographic markets. Economic uncertainty will likely impact M&A activity overall; however, companies with localized steady performance are always in vogue for buyers.

Reflecting on 2022

Before the books were closed on 2021's record-breaking earnings reports for CM, the federal government passed a massive $1.2 trillion infrastructure bill. The IIJA was a generational boon, coming off decades of underinvestment in public works and creating optimism for 2022. Aggregates, cement and hot-mix asphalt producers were set for a five-year super-cycle, and ready-mix concrete was to be buoyed by a resurgence of residential development in an era of low interest rates, strong consumer balance sheets and generational dynamics.

Figure 2: Federal Infrastructure Funding

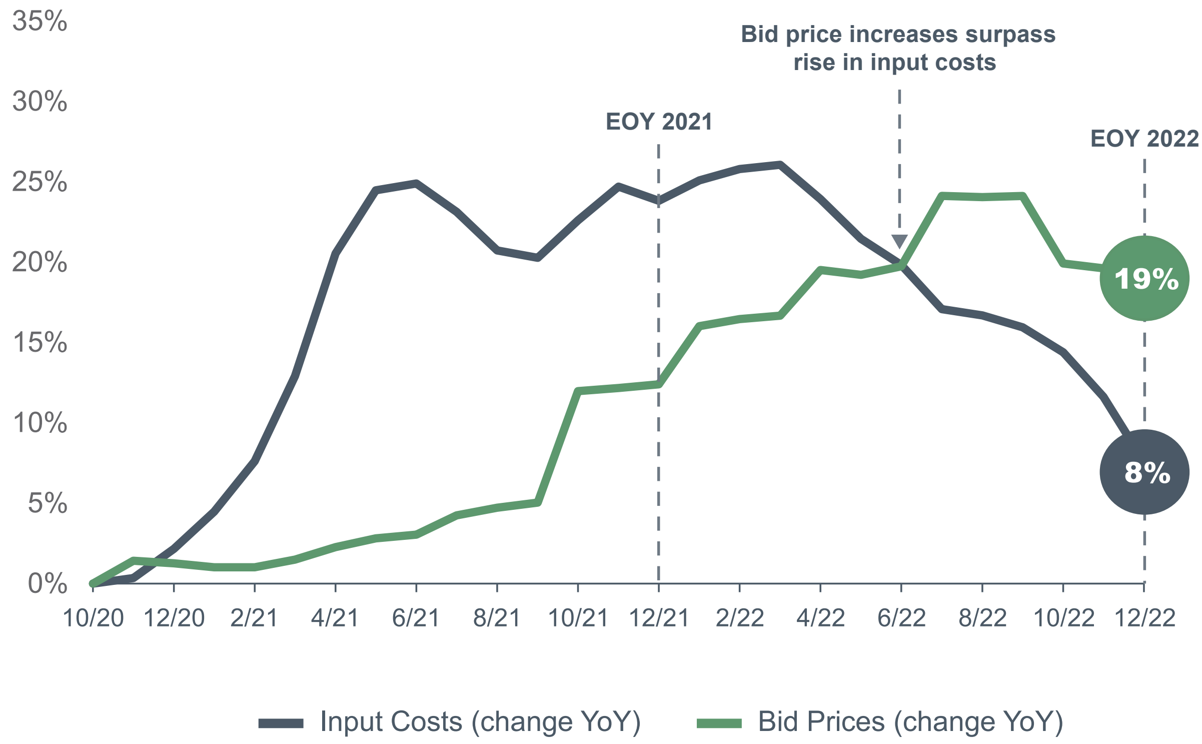


Source: FHWA, FMI Research

In fact, 2022 would be another strong year for CM performance, but not without its challenges. In February inflation reached a 40-year high, dampening much of the high spirits brought about by the IIJA legislation. Later that month, Russia invaded Ukraine, inspiring skittish behavior in financial markets around the globe and dashing hopes for the supply chain to easily “catch up” to demand. Equipment became harder to source, and by summer the Federal Reserve had commenced the steepest series of rate hikes since the 1980s with designs to curb inflation.

To further complicate issues, the highly anticipated infrastructure funding from the IIJA was held up by bottlenecks at state Department of Transportation (DOT) offices. As seen in Figure 3, the growth in input costs for nonresidential construction greatly outpaced bid prices through June of 2022. This movement created a disconnect between DOT lettings and contractor bids, holding up IIJA projects.

Figure 3: Nonresidential Input Costs vs. Bid Prices



Source: Federal Reserve Bank of St. Louis

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>
> – Ken Simonson
> Chief Economist
> AGC

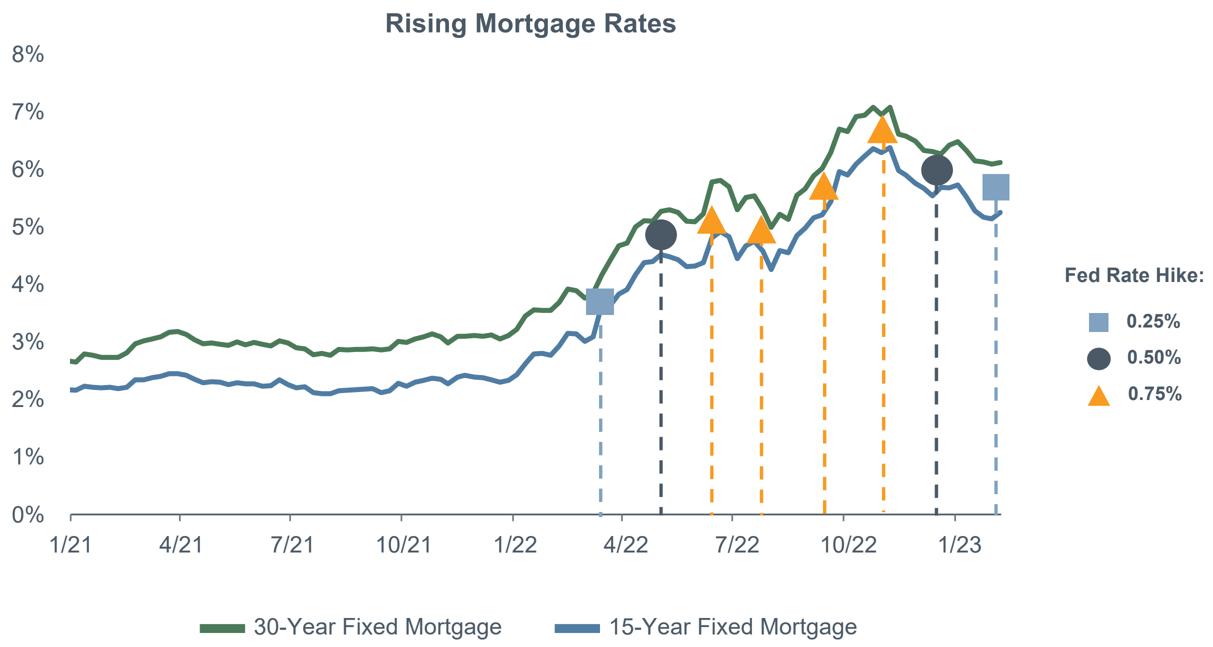
By June an inflection point was reached, and pricing began to catch up with costs. As bid/cost dynamics normalize, more IIJA projects will commence. Federal funding will be dispersed, providing optimism for the future, but as the AGC’s Chief Economist Ken Simonson perfectly noted, “the timing of public construction, while well-funded, remains unclear.”

Residential development saw peak spending through much of 2022. However, as borrowing rates increased, the red-hot residential market began to cool, and by year-end, housing inventories were on the rise.

As single-family housing activity slowed, some ready-mix concrete and cement producers were able to offset the decline by shifting volumes to multifamily, warehouses, manufacturing projects and data centers. Optimistically, long-term fundamentals underpinning the housing market remain strong with historic underdevelopment, deurbanization and growing demand from first-time buyers.

Overall, CM firms adjusted well to the year’s challenges, successfully passing on price hikes and benefiting from the first drips of infrastructure spending. Amid the headwinds, there were several bright spots:

Figure 4: Mortgage Rates and Fed Rate Hikes



Source: Freddie Mac

Construction spending as a whole saw growth of 8.5% year on year, unadjusted for inflation, per an analysis of Census Bureau data by the Associated General Contractors of America (AGC).

Solid performance in the broader construction industry indicated success for CM. Earnings reports in late 2022 were celebratory for public firms: Holcim Group recorded record net sales in the third quarter of 2022, while Vulcan Materials saw 38% growth in revenue, and Martin Marietta announced double-digit pricing growth.

"Continued pricing momentum more than offset a 42% increase in liquid asphalt," reported Vulcan Materials, which recorded growth of 111% in cash gross profit. Likewise, on the company's third quarter 2022 earnings call, Summit Materials CEO Anne Noonan cited the strongest year-on-year organic pricing growth in company history for aggregates, cement and ready-mix. Several companies have already signaled price increases in early 2023, expecting further pricing gains to expand margins throughout the year.

Additionally, the passage of the $280 billion Creating Helpful Incentives to Produce Semiconductors and Science (CHIPS) Act in August brought hope to bolster the U.S. manufacturing sector.

At the close of 2022, CM firms indicated that demand remained strong despite increased costs from inflation. Additionally, IIJA funding began hitting backlogs, which will boost many aggregate and asphalt producers. The dynamics of state DOTs will dictate the flow of funds for 2023, as some have indicated that infrastructure investments will be key pieces in their 2023 agenda.

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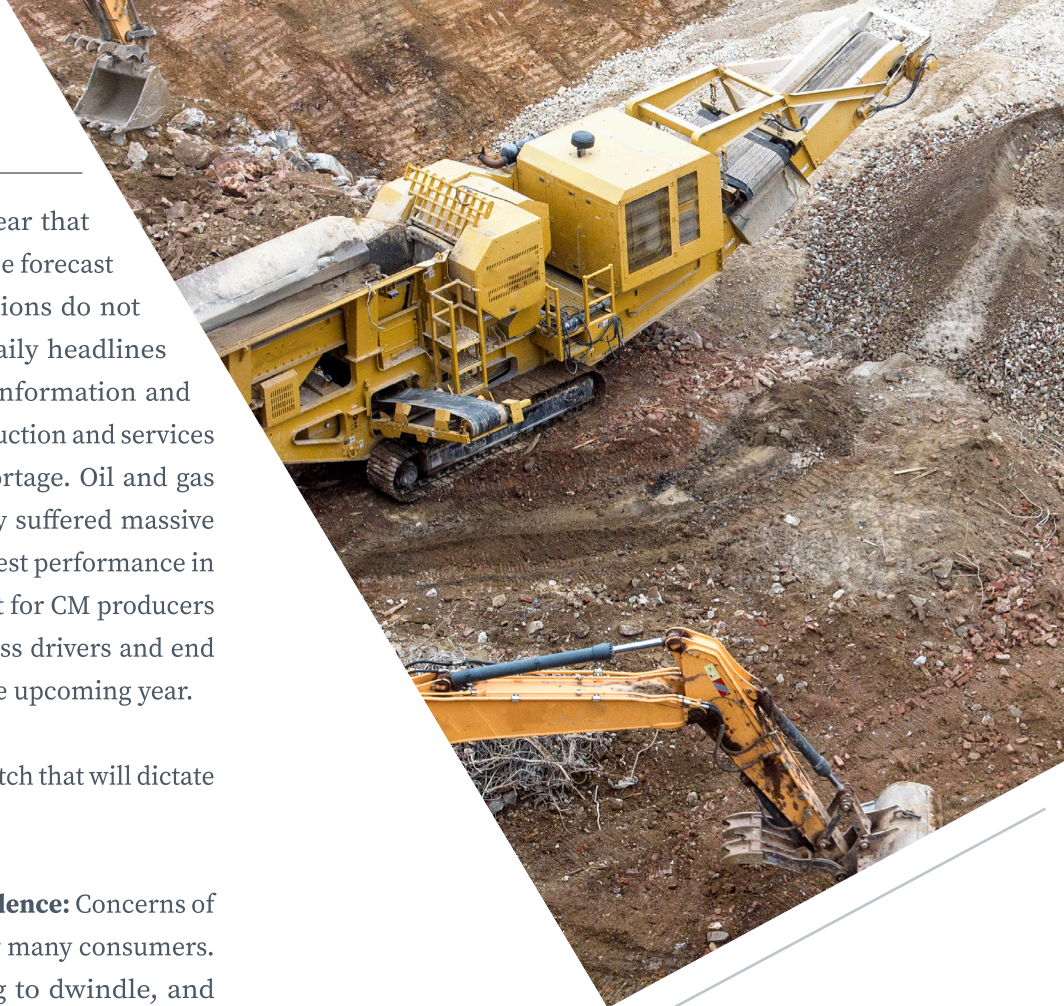

Outlook for 2023

Looking ahead to 2023, it is clear that economic performance cannot be forecast through a "single lens." Recessions do not affect all industries equally. Daily headlines announce mass layoffs in the information and technology sectors, while construction and services industries proclaim a labor shortage. Oil and gas companies, which have recently suffered massive losses, are now reporting their best performance in years. To this end, it is important for CM producers to focus on their specific business drivers and end markets to achieve success in the upcoming year.

There are five key elements to watch that will dictate 2023 performance.

Recession and Consumer Confidence: Concerns of a recession are front of mind for many consumers. Pandemic savings are starting to dwindle, and consumer debt is on the rise. In June 2022 consumer sentiment hit an all-time low and has remained well below historical averages. Residential, one of CM's most consumer-facing end markets, has already shown signs of slowing. If weakening consumer spending goes from bad to worse, it could foreshadow hard times to come for other sectors as well. Producers largely tied to nonbuilding construction and government funding may be better positioned to weather any economic downturn.

Inflation and Interest Rates: Inflation remains the all-consuming question for consumers, firms and Jerome Powell as 2023 unfolds. Though the pace of inflation declined for seven consecutive months starting in June 2022, reaching 6.4% in January 2023, many are divided on the magnitude and frequency of rate hikes required to bring inflation back to the Federal Reserve's long-term target. In early February the Fed increased rates by a quarter percent, smaller than prior increases. This measured approach shows the Fed is committed to using its toolbox to fight inflation while also showing receptiveness to positive incoming economic data. Daily news has been inconsistent, making capital spending and pricing plans especially difficult for CM operators. The next few months of inflation data will be especially important as they set the economic table for the Fed's interest rate strategy.

IIJA Rollout: Construction materials producers had a strong year in 2022, even without significant distributions from the highly anticipated IIJA. Much like the CM industry, state DOTs are not immune to the labor shortage. Constrained manpower, along with regulatory impediments, slowed lettings. But funding intended for 2022 did not vanish into thin air. Backlogs of new projects in development would suggest an increased rollout of IIJA-funded projects in 2023. How and when these projects materialize will drive performance for materials producers.

Demand and Backlogs: Strong demand became the theme for CM as 2022 progressed. That said, production of crushed stone and sand and gravel in the fourth quarter showed signs of softening, likely due to the slowdown in single-family construction. While a near-term residential slowdown is expected, long-term housing fundamentals and demand in other end markets remain strong. FMI is projecting double-digit increases for manufacturing and commercial spending as well as substantial highway and street spending. Balancing the good with the bad will be a key for 2023.

Global Events – War, COVID, etc.: Since early 2022, the U.S. has been caught in the ripple effect of two international developments, both constraining global supply chains: the Russia-Ukraine War and China's Zero-COVID lockdowns. The Russia-Ukraine conflict has had significant impacts on the world's energy supply. Though more prevalent in the EU, the U.S. battled soaring gas prices, adding further fuel to the inflation bonfire. Supply chains are adapting, and widespread calls for onshoring are gaining traction. Trade relief is also supported by the recent wind-down of Zero-COVID in China. As a result, the New York Fed's Global Supply Chain Pressure Index (GSCPI) hit its lowest mark since February 2020. Global economics looks promising, but there is much to be seen, especially with news of a Russian offensive this spring.

FMI forecasts total Construction Put-in-Place spending to fall 2% in 2023, driven significantly by decreased residential spending. For aggregate and ready-mixed concrete producers with large exposure to single-family construction, the Fed's current rate hiking schedule spells continued struggle. Diversification of end markets may play a key role in surviving any potential downturn. Producers looking to mitigate the expected single-family downturn can find solace in sustained demand for nonresidential construction. Manufacturing and commercial are expected to boom in 2023 with the support of federal stimulus and continued demand for e-commerce infrastructure.

FMI expects strength in nonbuilding spending, estimating an 8% increase in 2023, thanks to support from the IIJA. Highway and street spending, a significant driver for aggregates and hot-mix asphalt production, began to accelerate in the fourth quarter of 2022. With guaranteed federal funding, FMI projects steady spending increases for the sector through 2026 as federal stimulus is released.

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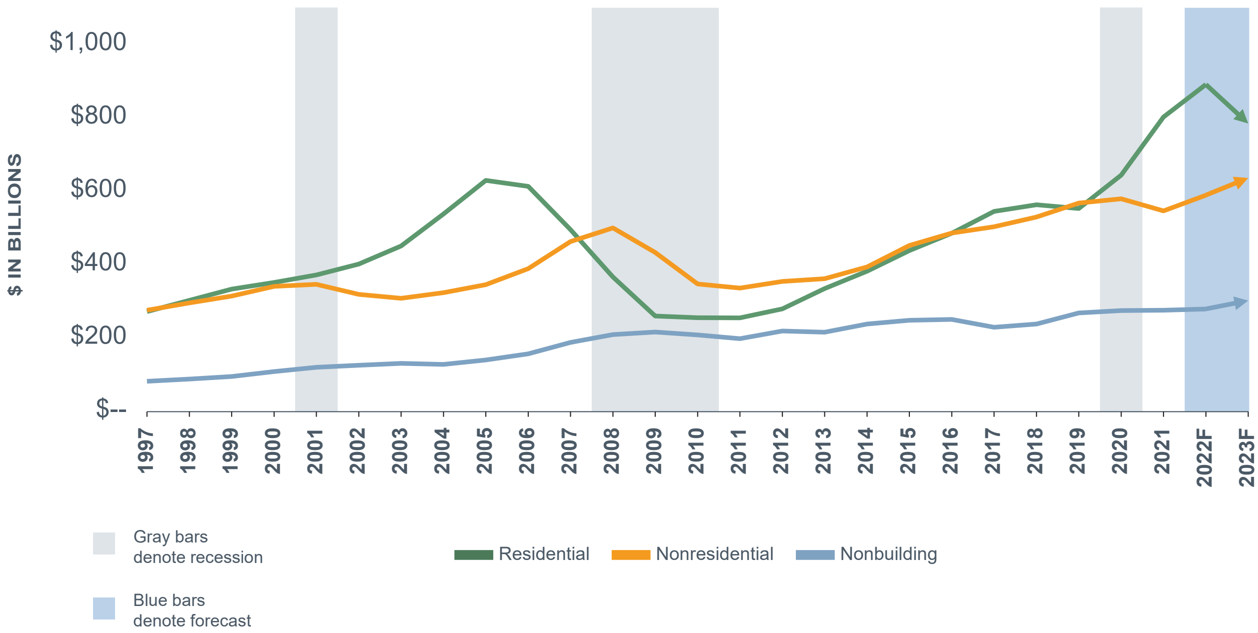
Figure 5: FMI Construction Put-in-Place Spending Forecast



Source: FMI

Broad macroeconomic trends are a good bellwether for performance, but one must remember "Construction is local." This is especially true for CM operations, which service a somewhat narrow jurisdiction. County and state investment, as well as private development, will not always follow the contours of the economic downturn. Rather, there will be opportunities in markets where the population is growing even in a worst-case scenario.

While access to cheap borrowing costs was dialed back in 2022, M&A activity still kept apace of historic norms. The need for public companies to grow, coupled with factors like talent shortages, means that there is still a strong incentive to pursue strategic investments. Bigger deals gave way to more bolt-on activity as buyers looked at ways to deepen their reach in existing markets and geographies.

Despite a slowdown by end of year, 2022 brought several large strategic acquisitions. In July **CalPortland** purchased a California cement plant and other assets from **Martin Marietta Materials, Inc.** In November **SRM Concrete** completed the acquisition of a subsidiary of U.S. Concrete, Inc., which is owned by **Vulcan Materials Company**, entailing 28 ready-mix locations in New York, New Jersey and Pennsylvania.

We also saw market expansions for **CRH Americas Materials**, which acquired Kentucky-based Hinkle Contracting Co.; **Vulcan's** purchase of Syar, a large northern Californian CM producer; and a spinoff for **MDU Resources Group, Inc.** of its CM arm, Knife River Corporation.

Going into 2023, we see more selective growth through M&A as buyers drill down on existing markets or geographies where operations are proven. Buyers on the whole are not overleveraged and need to continue to grow – a boom in public activity could boost interest in CM players, especially those with strong performances over the past year.

A move to strengthen market positions supports bolt-on acquisitions, and activity here may be colored by environmental, social and governance (ESG) objectives where it makes strategic sense. Recycled materials producers offer an appealing value proposition for states with environmentally friendly sourcing mandates as well as those markets with low supply of virgin aggregates.

Though interest from private equity has historically been limited, the broad strokes of the industry make for an attractive investment: high fragmentation and still largely family-owned, often with a need to transition ownership and to bolster staffing during a time of full backlogs. Near-term dynamics do not change this, and supply of sellers will hold.

Conclusion

National and global economic news has been a mixed bag, and a feeling of disconnect between headlines and regional construction performance may start to emerge. Construction is a local business with unique drivers for materials producers in each market. Describing the outlook for 2023 as "good" or "bad" is too simplistic. The effect of interest rates on residential construction is apparent, but funding for nonresidential and nonbuilding is accelerating, and backlogs are up. Justifications for alarm are easy to find; for now, however, CM demand is strong, and the path forward remains promising.

In regard to mergers and acquisitions – steady industry performance buoyed activity in 2022 despite broad economic uncertainty. The annual volume of CM transactions kept pace, though slowing mildly in the second half of the year. Longer-term industry dynamics and limits to organic growth support strategic M&A for the construction materials industry. Solid operational performances from CM firms in 2023, combined with strong backlogs from IIJA projects, will set up CM targets for productive conversations with buyers in the coming year.

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East Coverage

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