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VALUE FOCUS

Construction & Building Materials

Third Quarter 2019 | Segment Focus: Roads, Bridges, and Highways

Executive Industry Trends

- Residential construction has begun to rebound out of its trough after declining through the second half of 2018. Mortgage rates have declined to multi-year lows.
- State and local governments have increased spending on much-needed infrastructure projects but are beginning to face budgetary constraints and the expiration of FAST Act funding.
- Ongoing trade tensions and uncertainty have cast a cloud over future business investment as industrial output has stagnated.
- The Fed cut the federal funds rate in July and September, the first cuts since 2008, as the 10-year treasury yield has continued to decline.

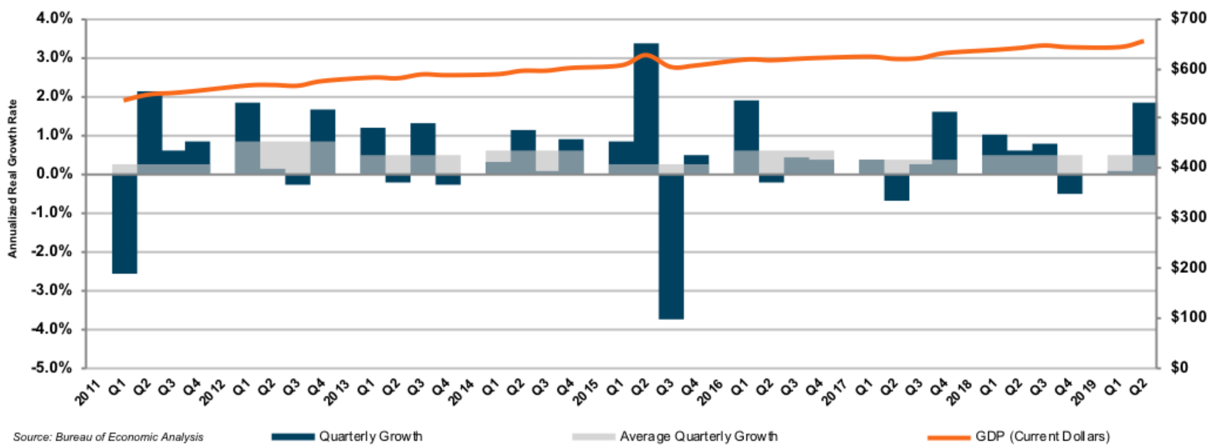
In This Issue

Construction Overview

Construction & National GDP

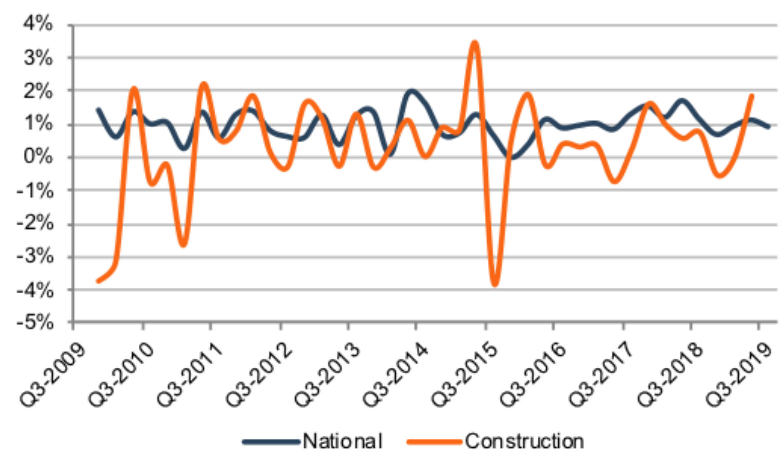
National GDP rose 3.8% over the past year through 3Q19, decelerating from period highs. Since 2009, construction has averaged 3.4% of national GDP, and it accounted for 3.1% of GDP over 2Q19 (3Q19 construction GDP not yet available). Construction has steadily recovered since the decline precipitated by the 2008 financial crisis, experiencing growth consistent with that of the national GDP. Fluctuations in construction GDP have now stabilized, with most quarterly growth rates lying in the plus or minus 0-2% range since 2012. Year over year construction GDP has increased 2.1%. The deceleration in construction GDP growth over the second half of 2018 was primarily due to declining residential construction activity. Despite improved residential construction performance, political and trade tensions are weighing on the outlook for industry growth as well as concerns over the length of the current credit cycle.

Construction Gross Domestic Product



Source: Bureau of Economic Analysis

% Change in GDP



Source: tradingeconomics.com | U.S.Bureau of Economic Analysis

Construction GDP	
Period	**% Change**
Q-o-Q	1.9%
Y-o-Y	2.1%

National GDP	
Period	**% Change**
Q-o-Q	0.9%
Y-o-Y	3.8%

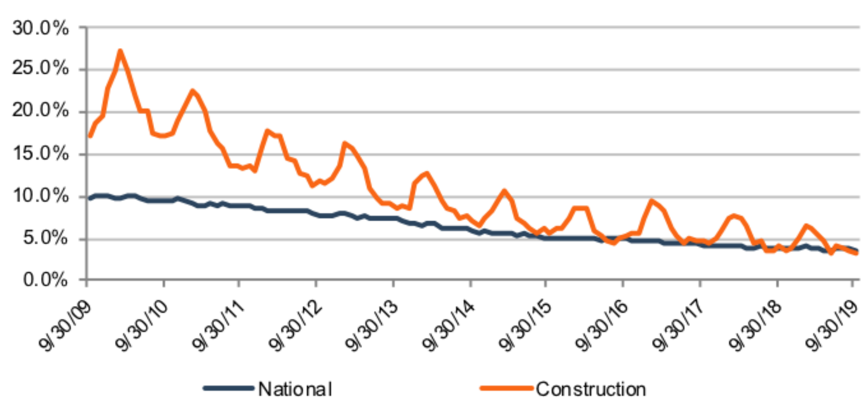
Construction Overview

Construction & National Unemployment

The Federal Reserve believes a healthy economy typically has an unemployment rate between 4.5% and 6.0%. The current level of 3.5% falls below this range, indicative of a tight labor market. The unemployment rate in September fell to the lowest rate of the ten year period.

The unemployment rate in the construction industry is typically more volatile because it is a cyclical and seasonal industry. The major contributing factor to the seasonal nature of the industry is the weather. Production of materials and projects generally decrease during the colder, winter months. Construction unemployment is currently at 3.2%, below the level of 4.1% at the same time last year. The construction unemployment rate of 3.2% matches the period low of May 2019. A lack of skilled laborers has become an industry-wide issue and has contributed to wage growth and increased costs for builders.

Unemployment Rate



Source: U.S. Bureau of Labor Statistics

Note: In the above graph, the national unemployment rate is seasonally adjusted, but the construction unemployment rate is not in order to show seasonality and recent trends.

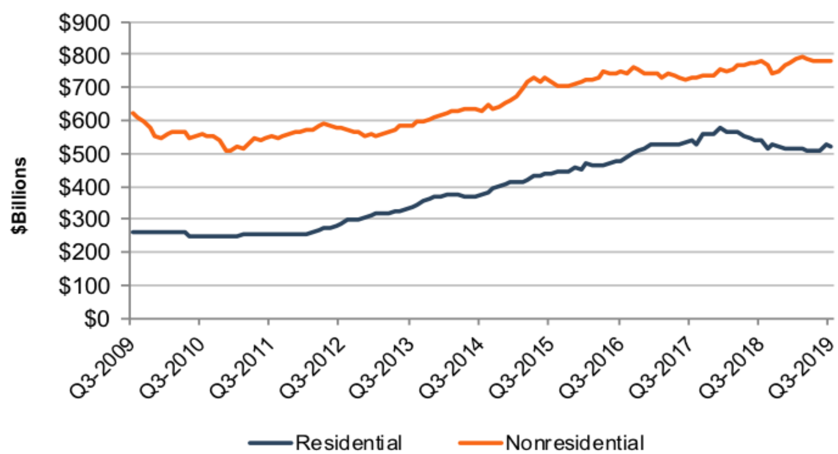
Construction Overview

Value of Construction Put-in-Place

The value of construction put-in-place is the total value of construction work done in the U.S. for a particular period. The U.S. Census Bureau tracks this data and reports the total monthly. This value includes, but is not limited to, the building materials costs, labor costs, profit, engineering costs, interest, and taxes.

Year-over-year put-in-place construction has decreased by 3.2% for residential and decreased by 0.1% for nonresidential. Nonresidential construction increased slightly by 0.4% quarter-over-quarter through September 2019. After declining in 2018, put-in-place residential construction increased in the third quarter of 2019 as the sharp rise in mortgage rates in late 2018 has reversed course although concerns about affordability and availability remain. Nonresidential construction has been supported by increased spending at the local and state government level on public infrastructure over the past year due to a large backlog of deferred maintenance. However, public spending on infrastructure softened in the third quarter. A decline in capital investment related to oil drilling also weighed on overall nonresidential construction in the third quarter.

Value of Construction Put-in-Place



Source: U.S. Census Bureau

Residential	
Period	**% Change**
Q-o-Q	2.7%
Y-o-Y	-3.2%

Nonresidential	
Period	**% Change**
Q-o-Q	0.4%
Y-o-Y	-0.1%

Sector Focus

Roads, Bridges, and Highways

State and local governments are typically in charge of their construction projects, but they rely on federal funding to complete many projects. State and local governments have increased much-needed spending on infrastructure projects as the prospects of the President's infrastructure plan have continuously diminished among more pressing political concerns of the ongoing impeachment inquiry and the trade dispute with China. After a period of fiscal restraint, state and local governments have begun to work through a backlog of deferred maintenance with growth being led by several of the largest states such as California's SB1 Bill. However, analysts are concerned the current trend is unsustainable and other fixes such as more public-private partnerships (3Ps), infrastructure funds, and improving the tax system are in order. While prospects of a grand infrastructure plan may be revived in the 2020 elections, the Fixing America's Surface Transportation (FAST) Act is set to expire in 2020 and funds will need to be reauthorized, potentially later this year.

With funding playing such a critical role in the industry, companies focus a considerable amount of effort on future bids and winning contracts. Backlogs stimulate future revenue and the pipeline is frequently used as an indicator of future revenue. The companies in our peer group reported some backlog divergence in their third quarter results. Granite Construction's total backlog increased 44% (over $1 billion) year-over-year as revenue increased 3% from 3Q18. However, Granite management indicated that they would be stepping away from large heavy civil projects due to project disputes over unanticipated costs and protracted resolution issues. Tutor Perini's backlog was up 28% year-over-year to $10.9 billion and revenue increased 6% in 3Q19 compared to the third quarter last year. Tutor Perini has already been awarded three major projects ($3 billion) as part of the Los Angeles metro rail system, the biggest current construction project in the country. Sterling Construction experienced an increase in their backlog of 9% compared to year-end 2018. Sterling also acquired Plateau Excavation, a Georgia-based infrastructure contractor, in the third quarter for $400 million (5.5x EBITDA). The Plateau acquisition gives Sterling a presence in the Southeastern U.S. as well as in the data center and warehouse construction space.

Ongoing trade tensions between the U.S. and China have led to increased costs for imported steel and aluminum while cement prices have been less exposed to current trade disruptions. Rising steel and aluminum costs should still filter through to higher construction costs for the industry as a whole and companies tied to the construction industry. Analysts are concerned these rising prices will particularly affect infrastructure projects as local budgets are already strained with increased spending. Geopolitical and trade tensions have weighed on U.S. nonresidential construction stock prices so far in 2019 despite underlying strong fundamentals and opportunities for growth. Uncertainty over trade negotiations may continue to weigh on industrial production and investment.

Roads, Bridges, and Highways

Government Funding for Highways and Local and State Government Investment

Building materials are a crucial input to construction projects. Without funding, however, construction projects cannot be completed. Much of this funding comes from public resources, so the industry is typically concerned with the level of government spending on construction activity. Government consumption expenditures and gross investments reached high levels during the recession to boost the economy and declined significantly in the years following. After stagnating for much of 2016 and 2017, GCI grew throughout 2018 and the first three quarters of 2019 reaching the highest levels since 2010. The growth in GCI was boosted by increased military spending as well as increased public infrastructure investment at the state and local level.

The value of road and highway construction increased 5.5% year-over-year as state and local governments increased spending on infrastructure in place of increased federal spending. However, road and highway construction declined 3.2% from the second quarter of 2019 after peaking in April. As state and local governments come under more budgetary pressures, alternative sources of funding need to be tapped.

Government Consumption and Investment

Source: St. Louis Fed

Value of Highway and Street Construction

Source: U.S. Census Bureau

Government Consumption and Investment	
Period	**% Change**
Q-o-Q	0.4%
Y-o-Y	2.2%

Value of Highway and Street Construction	
Period	**% Change**
Q-o-Q	-3.2%
Y-o-Y	5.5%

Roads, Bridges, and Highways

Price of Cement

Road contractors submit bids to local and state governments, and construction jobs are awarded to the lowest bidder. Higher input costs, like cement, decrease both the volume of projects the government is willing to start and the profit margins for contractors. Delivery is the most significant cost factor and proximity to a supplier plays a large role in price. Because the product is sold in large, heavy quantities, it is a regional product. The cement producer price index tracks the average change in price received by cement producers. Prices have been increasing due to increased demand within the construction industry resulting from increased activity in both the residential and nonresidential sectors. Continued increases in downstream demand may exceed current domestic production capacity and lead to further price increases as barriers to entry for new supply remain high.

Cement Producer Price Index

Source: St. Louis Fed | U.S. Bureau of Labor Statistics

Cement Producer Price Index	
Period	**% Change**
Q-o-Q	-0.4%
Y-o-Y	2.7%

Roads, Bridges, and Highways

Yield on 10-Year Treasury

The yield on 10-Year Treasury Bonds can indirectly affect the road contracting industry. Higher interest rates make construction projects more expensive to undertake but they may also signify increased optimism about economic growth. As seen in the chart below, the 10-year yield experienced an upward trend for much of 2017 and 2018 as the Fed raised short term interest rates. The 10-year yield has decreased by 130 basis points over the past year due to a shift in the Fed's stance on interest rates over concerns of the flattening yield curve. The Fed lowered the federal funds rate in July and September, the first rate reductions since 2008.

One interest rate measure to watch is the spread between 10-year and 2-year treasury yields. A spread approaching zero or even crossing into negative territory has historically preceded a recession and potentially signals that the Fed has tightened rates too much. After dipping into negative territory in August 2019, the spread pulled back in September as the Fed continued to cut the federal funds rate which has a greater impact on 2-year yields. The market appears to be signaling increased odds of further short-term rate reductions.

Yield on 10-Year-Treasury Bonds

Source: St. Louis Fed

Yield on 10-Year-Treasury Bonds	
Period	**% Change**
Q-o-Q	-37 BPS
Y-o-Y	-130 BPS

Sector Round-up

Nonresidential Construction

Corporate profit is essential for companies not only to survive, but to grow and expand. When corporate profit increases, companies are more willing and able to open new branches and divisions. These additions lead to more commercial construction. As seen in the chart below, corporate profit has increased over the past year to the highest level of the past ten years. In addition to favorable macroeconomic trends discussed in other sections, the U.S. Tax Cuts and Jobs Act of 2017 lowered the corporate tax rate from 35% to 21%. The dip in the fourth quarter of 2017 is partially due to one-time deferred tax asset write-downs incurred by companies owing to the new tax rate. Uncertainty regarding the global trade outlook given ongoing tensions between the U.S. and China may weigh on future business investment.

Strong consumer spending, driven by increased wage and job growth, helped offset flat corporate profitability and capital investment throughout most of 2019. However, consumer spending outside of gas stations fell 0.2% between August and September, the lowest monthly difference since February. Excluding spending in the volatile category of motor-vehicle and parts stores, retail spending was unchanged in September.

Office rental vacancy can also be a signal for new commercial construction demand. Low vacancy rates indicate a need for more space for companies to conduct business, which is a boon for the nonresidential construction industry. Both suburban and downtown vacancy rates have remained stable at cycle lows for the previous couple of years as strong demand has absorbed supply as it has become available. New construction has been predominantly concentrated in a small number of metro markets such as Manhattan, Washington D.C., and San Francisco. Labor constraints and slowing employment growth may slow future spending on office real estate.

Value of Highway and Street Construction

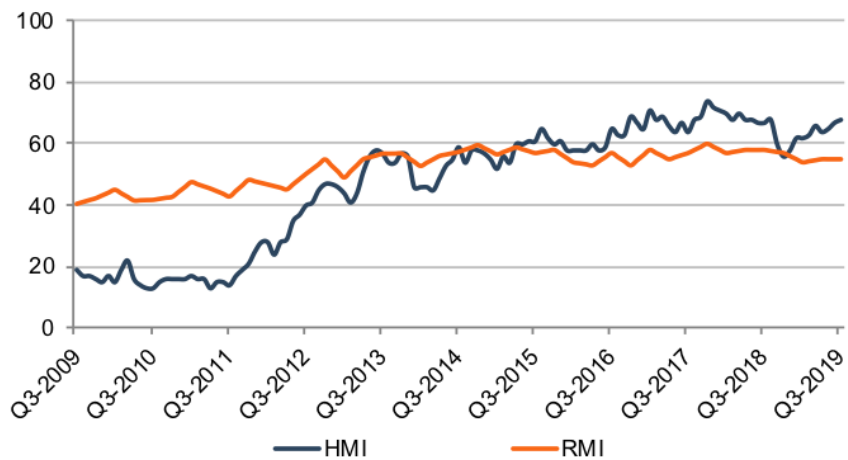
Corporate Profit	
Period	**% Change**
Q-o-Q	-0.6%
Y-o-Y	-0.4%

Source: St. Louis Fed

Residential Construction

The National Association of Home Builders (NAHB) conducts two separate surveys, the Housing Market Index (HMI) and the Remodeling Market Index (RMI), to measure confidence in the home building industry. Respondents rate their activity on a scale from 1-100 with 50 being average. The HMI is produced monthly and asks respondents to rate market conditions both at present and looking forward six months. The monthly index has remained above 50 since July 2014 and reached a ten year high of 74 in December 2017. The HMI recovered in the first half of 2019 after housing market activity had softened in late 2018. Additionally, American homebuilders are less exposed to ongoing trade disputes with China and the European Union. The RMI is produced quarterly and asks respondents to rate their work volume as either higher or lower than the previous quarter. The quarterly index has fluctuated between 50 and 60 since the second quarter of 2013.

NAHB HMI and RMI



Source: National Association of Home Builders

Note: RMI is measured quarterly and approximated for a monthly basis using a straight-line approach

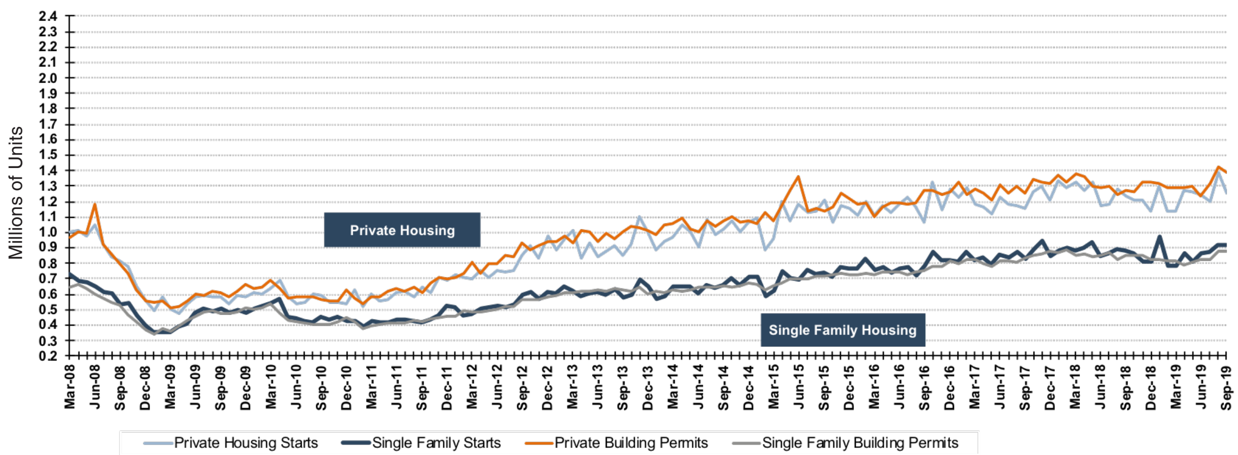
NAHB HMI	
Period	**% Change**
Q-o-Q	6.3%
Y-o-Y	1.5%

NAHB RMI	
Period	**% Change**
Q-o-Q	0.0%
Y-o-Y	-5.2%

Residential Construction
(cont.)

Building permits and housing starts are two important indicators for the home building industry. Both reflect demand, consumer confidence, and the feasibility of financing construction projects. Building permits can be issued and then shelved by builders; therefore, housing starts are a better focused measure of current activity within the industry. After declining nearly 75% from 1Q06 to 1Q09 as the housing bubble unwound, housing permits and starts have steadily recovered but are unlikely to reach pre-recession highs. After mixed performance throughout most of 2018, housing starts have improved throughout 2019 as demand for new homes increased in response to declining mortgage rates.

Seasonally Adjusted Annualized Rates of New Housing Starts and Building Permits



Source: U.S. Census Bureau
Note: Permits at a given date are generally a leading indicator of future starts. Beginning with January 2004, building permit data reflects the change to the 20,000 place series.

Private Housing Stats	
Period	**% Change**
Q-o-Q	1.2%
Y-o-Y	1.5%

Single Family Stats	
Period	**% Change**
Q-o-Q	6.1%
Y-o-Y	4.4%

Private Building Permits	
Period	**% Change**
Q-o-Q	12.9%
Y-o-Y	9.5%

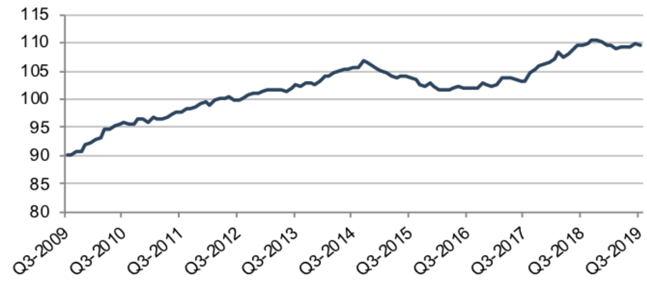
Single Family Building Permits	
Period	**% Change**
Q-o-Q	7.0%
Y-o-Y	3.2%

Building Materials

Industrial Production Index and Value of Utilities Construction

The Industrial Production Index is an indicator of economic activity that measures real production output of the manufacturing, mining, and utilities industries. It acts as a barometer for the level of demand for industrial products and manufacturing activity. After oscillating for a couple of years, IPI steadily increased for most of 2017 and 2018. In December 2018, IPI reached its highest level of the examined period but has experienced limited growth over the first three quarters of 2019. General Motors strikes and plant closures, as well as Boeing's issues with the 737 MAX, contributed to the flat IPI over the previous three quarters.

Industrial Production Index



Source: St. Louis Fed

Industrial Production Index	
Period	**% Change**
Q-o-Q	0.3%
Y-o-Y	-0.1%

Cement and ready-mix concrete are used in most construction projects involving the utilities subsector such as transportation, energy, gas, water, and sewage. There will always be a need for such infrastructure, so building materials companies can rely on this revenue stream even though the growth rate of new projects fluctuates. The value of utilities construction has increased 7.3% year-over-year. Increased renovation and safety requirements have driven an increase in power construction spending as well as a focus on natural gas and renewable energy sources. Spending on water supply construction is expected to increase as most of the country's pipeline system was installed in the mid-20th century and will need to be replaced or renovated.

Value of Utilities Construction

Source: U.S. Census Bureau

Value of Utilities Construction	
Period	**% Change**
Q-o-Q	1%
Y-o-Y	7.3%

Bellwether Stocks & Industry Participants

	Ticker	Price at 9/30/19	52-Week Perf.	LTM Revenue	Enterprise Value	Debt / MVTC	EBITDA Margin	EV / EBITDA (x)	TEV / Next Yr EBITDA (x)	Price / LTM Earnings
Residential										
Beazer Homes USA, Inc.	NYSE: BZH	14.90	41.9%	2,088	1,688	72.8%	3.5%	22.97	8.21	NM
D.R. Horton, Inc.	NYSE: DHI	52.71	25.0%	17,593	22,297	14.8%	12.4%	10.21	9.35	12.13
KB Home	NYSE: KBH	34.00	42.2%	4,343	4,676	38.3%	8.1%	13.22	8.42	12.39
Lennar Corporation	NYSE: LEN	55.85	19.6%	21,747	27,484	36.9%	11.5%	11.02	9.95	9.18
LGI Homes, Inc.	NasdaqGS: LGIH	83.32	75.6%	1,658	2,544	28.4%	12.3%	12.52	10.05	12.27
M.D.C. Holdings, Inc.	NYSE: MDC	43.10	57.4%	3,071	3,399	29.7%	9.5%	11.67	7.72	13.25
NVR, Inc.	NYSE: NVR	3,717.35	50.5%	7,428	13,417	4.8%	14.3%	12.66	13.00	15.77
PulteGroup, Inc.	NYSE: PHM	36.55	47.6%	10,195	12,451	23.6%	13.5%	9.04	8.09	11.12
Taylor Morrison Home Corporation	NYSE: TMHC	25.94	43.8%	4,753	4,665	44.1%	8.2%	11.90	10.18	13.34
Meritage Homes Corporation	NYSE: MTH	70.35	76.3%	3,539	3,628	33.3%	9.1%	11.24	8.75	12.18
TRI Pointe Group, Inc.	NYSE: TPH	15.04	21.3%	3,074	3,457	41.1%	9.9%	11.33	10.57	11.30
Median - Residential			**44%**	**4,343**	**4,665**	**33.3%**	**9.9%**	**11.67**	**9.35**	**12.22**

All figures reported in millions, except per share data

Source: Capital IQ

Bellwether Stocks & Industry Participants

	Ticker	Price at 9/30/19	52-Week Perf.	LTM Revenue	Enterprise Value	Debt / MVTC	EBITDA Margin	EV / EBITDA (x)	TEV / Next Yr EBITDA (x)	Price / LTM Earnings
Building Materials										
Eagle Materials Inc.	NYSE: EXP	90.01	5.6%	1,403	4,708	21.5%	27.0%	12.41	10.57	92.60
Martin Marietta Materials, Inc.	NYSE: MLM	274.10	50.6%	4,354	20,681	16.7%	27.9%	17.03	15.63	29.87
Summit Materials, Inc.	NYSE: SUM	22.20	22.1%	2,157	4,387	43.9%	18.9%	10.78	9.45	587.15
U.S. Concrete, Inc.	NasdaqGS: USCR	55.28	20.6%	1,480	1,695	46.3%	11.0%	10.40	7.55	69.84
Vulcan Materials Company	NYSE: VMC	151.24	36.0%	4,831	23,328	13.8%	25.5%	18.93	16.85	33.09
CEMEX, S.A.B. de C.V.	BMV: CEMEX CPO	0.39	-44.6%	13,610	17,619	65.1%	15.9%	8.12	6.66	26.09
CRH plc	ISE: CRG	34.45	5.2%	31,933	39,179	32.8%	12.8%	9.60	8.63	15.37
HeidelbergCement AG	DB: HEI	71.97	-8.2%	20,764	27,355	48.9%	16.0%	8.23	6.80	12.97
LafargeHolcim Ltd	SWX: LHN	49.23	-0.8%	27,929	45,414	35.1%	21.2%	7.66	6.77	13.10
Median - Building Materials			**6%**	**4,831**	**20,681**	**35.1%**	**18.9%**	**10.40**	**8.63**	**29.87**
Roads, Bridges, and Highways										
Granite Construction Incorporated	NYSE: GVA	32.13	-30%	3,390	1,624	24.2%	0.3%	162.95	7.45	NM
Sterling Construction Company, Inc.	NasdaqGS: STRL	13.15	-8.2%	1,035	373	20.4%	4.4%	8.28	5.85	15.02
Tutor Perini Corporation	NYSE: TPC	14.33	-23.8%	4,456	1,563	55.0%	5.8%	6.06	5.17	NM
Median - Roads, Bridges, and Highways			**-24%**	**3,390**	**1,563**	**24.2%**	**4.4%**	**8.28**	**5.85**	**15.02**

All figures reported in millions, except per share data

Source: Capital IQ

Note: CX, CRG, HEI, and LHN report in foreign currency. Margin and multiples unaffected and shown for analysis.

Bellwether Stocks & Industry Participants

	Ticker	Price at 9/30/19	52-Week Perf.	LTM Revenue	Enterprise Value	Debt / MVTC	EBITDA Margin	EV / EBITDA (x)	TEV / Next Yr EBITDA (x)	Price / LTM Earnings
Nonresidential										
AECOM	NYSE: ACM	37.56	15%	20,173	9,138	36.5%	4.6%	9.94	9.17	NM
Dycom Industries, Inc.	NYSE: DY	51.05	-40%	3,315	2,602	38.8%	9.2%	8.56	7.54	26.73
EMCOR Group, Inc.	NYSE: EME	86.12	14.7%	9,000	5,162	9.6%	6.0%	9.56	9.52	15.31
Fluor Corporation	NYSE: FLR	19.13	-67%	18,520	2,882	42.3%	-0.6%	NM	4.75	NM
Jacobs Engineering Group Inc.	NYSE: J	91.50	19.6%	12,738	12,696	10.2%	7.3%	13.65	11.68	43.55
MasTec, Inc.	NYSE: MTZ	64.93	45%	7,392	6,428	24.2%	10.9%	7.98	7.75	15.16
Quanta Services, Inc.	NYSE: PWR	37.80	13.2%	12,112	7,159	28.8%	7.4%	7.97	6.74	16.27
Median - Nonresidential			**15%**	**12,112**	**6,428**	**28.8%**	**7.3%**	**9.06**	**7.75**	**16.27**

All figures reported in millions, except per share data

Source: Capital IQ

Mercer Capital

Construction & Building Materials Industry Services

Mercer Capital provides valuation and transaction advisory services to the construction and building materials industries.

Industry Segments

Mercer Capital serves construction industry segments from to commercial and civil to residential. We also serve the building materials sector from aluminum and steel to brick, glass, and lumber.

Mercer Capital Experience

- Family and management succession planning
- Buy-side and sell-side transaction advisory assistance
- Conflict resolution and litigation support
- Trust and estate planning
- Buy-sell agreement valuation, design, and funding advisory

Contact a Mercer Capital professional to discuss your needs in confidence.

Contact Us

Timothy R. Lee, ASA
901.322.9740
leet@mercercapital.com

Nicholas J. Heinz, ASA
901.685.2120
heinzn@mercercapital.com

Brian F. Adams
901.322.9706
adamsb@mercercapital.com

MERCER CAPITAL
www.mercercapital.com

Mercer Capital

www.mercercapital.com