SEIZING THE OPPORTUNITIES AHEAD:

The 2022 Construction Materials Outlook

January 2022

EXECUTIVE SUMMARY

Construction Materials (CM)[1] firms saw steady growth and strong earnings in 2021, after the uncertainty in 2020 from the Covid pandemic. The U.S. Geological Survey estimates that aggregates output grew 4% year over year for both crushed stone and sand and gravel in the third quarter of 2021, which outpaces historic norms.[2] This growth continues to be driven by infrastructure spending and the expanding residential construction and e-commerce sectors.

Demand for CM is set to soar even higher with funding from the $1.2 trillion Infrastructure Investment and Jobs Act (IIJA), which Congress passed in November 2021. While the language is complex and introduces a new definition of "infrastructure," the result for traditional infrastructure is a once-in-a-generation investment. **For highways and streets, federal funding is projected to increase by as much as 55%[3] over the previous FAST Act baseline**.[4]

Given these large funding resources, we see strong, sustained demand for CM as projects to repair, maintain and modernize infrastructure kick off in 2022 and continue beyond 2026, addressing a massive backlog of repair needs. A booming residential market will continue to drive demand for CM as well, raising the question: **How will supply keep up?**

Federal infrastructure funds will fuel the CM industry from now through 2026, bolstering a sector already riding high from the housing surge. The industry must now find a way to maintain growth while battling inflation and a challenging labor supply. **Overall, FMI sees strong buyer appetite for M&A, with a focus on strategic deals.**

The "war on talent" is not a new topic for the sector. Up until now, CM firms have been creative in addressing labor shortages, but a scarcity of crews, drivers, plant operators and Department of Transportation (DOT) personnel will likely constrain production. While production demand will benefit from improvements in automation and extended production hours, labor shortages, inflation, interest rate hikes and supply chain issues present potential headwinds. Zooming out to the bigger picture, those who overcome the talent shortage will capitalize on the coming boom.

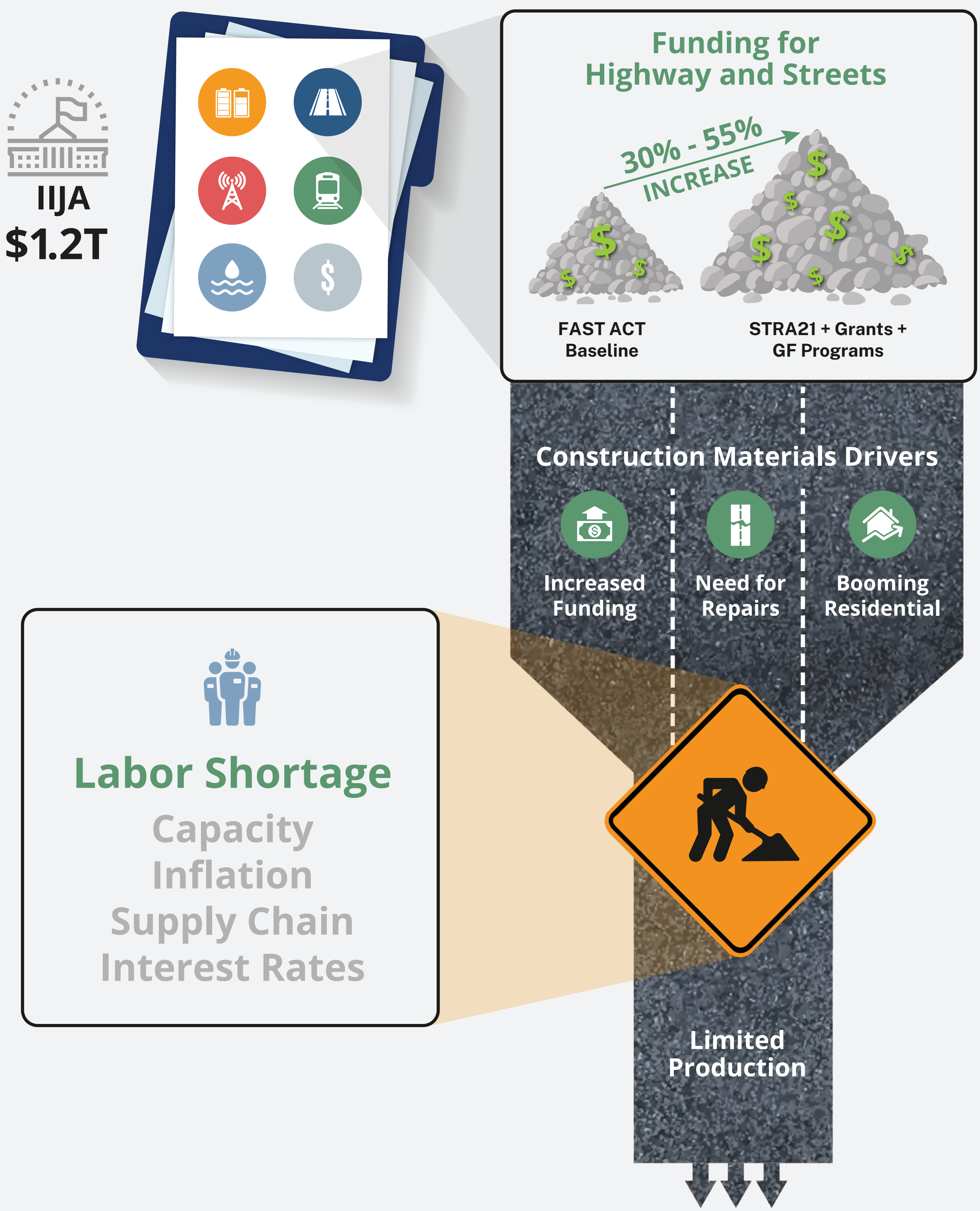
1 CM is defined as crushed stone, sand and gravel, hot-mix asphalt, ready-mixed concrete and cement.

2 "Mineral Industry Surveys: Crushed Stone and Sand and Gravel in the Third Quarter 2021." U.S. Geological Survey. Nov. 2021.

3 "NAPA Applauds U.S. House Passage of IIJA." National Asphalt Paving Association. Nov. 6, 2021.

4 The Fixing America's Surface Transportation (FAST) Act was passed in 2015.

What Does It All Mean for Construction Materials?



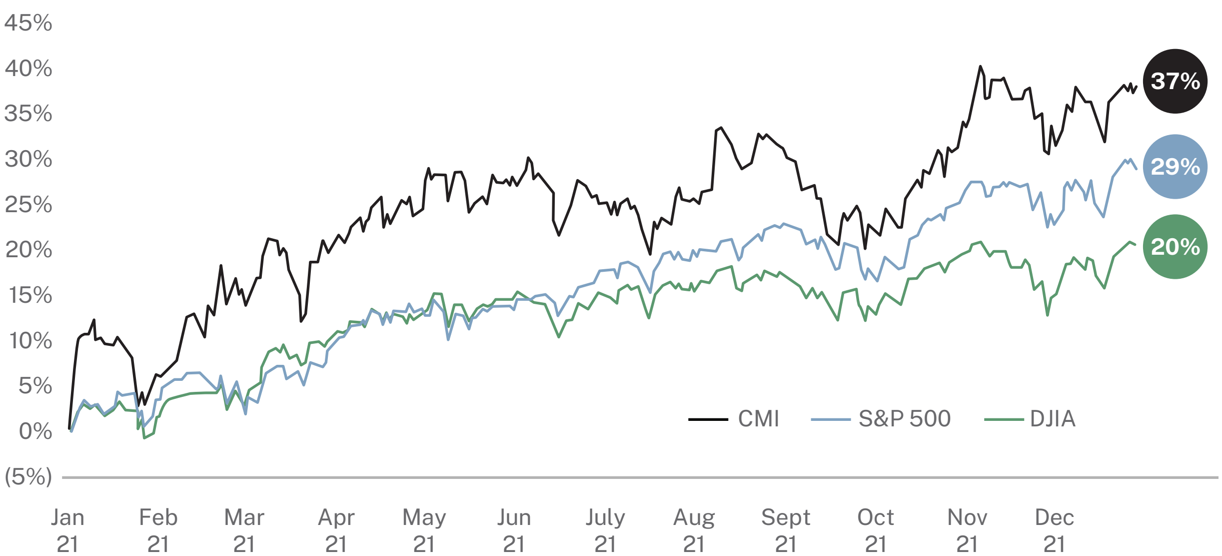
How Much Can We Build, Given These Issues?

2021 YEAR RECAP

Construction Materials Firms Outperformed in 2021

A year that began with cautious optimism finished with a rush of momentum. Viewed as a whole, the sector's financial performance was exceptional. FMI's Construction Materials Index (CMI), a proprietary index of 17 publicly traded CM firms, showed sustained growth throughout 2021. The CMI increased by 37%, outperforming the Dow Jones Industrial Average and S&P 500 over the last 12 months.

Figure 1: Construction Materials Outperformed Other Major Indices in 2021



Source: FMI, S&P Capital IQ

Beyond the financial markets, FMI has also seen sentiment from heavy civil and nonresidential contractors strengthen, predicting expansion in early 2022. In two of FMI's proprietary sentiment indices (where contractors are asked about their outlook for the next quarter), we have seen a return to pre-pandemic levels (scores above 50 indicate expansion while scores below 50 indicate contraction). FMI's Nonresidential Construction Index (NRCI) remained solidly expansionary.[5] The FMI Heavy Civil Construction Index (HCCI) also capped a year of upward movement in the fourth quarter.[6] (Note: polling took place before passage of the infrastructure bill, meaning there could be significant improvement in the next quarter.)

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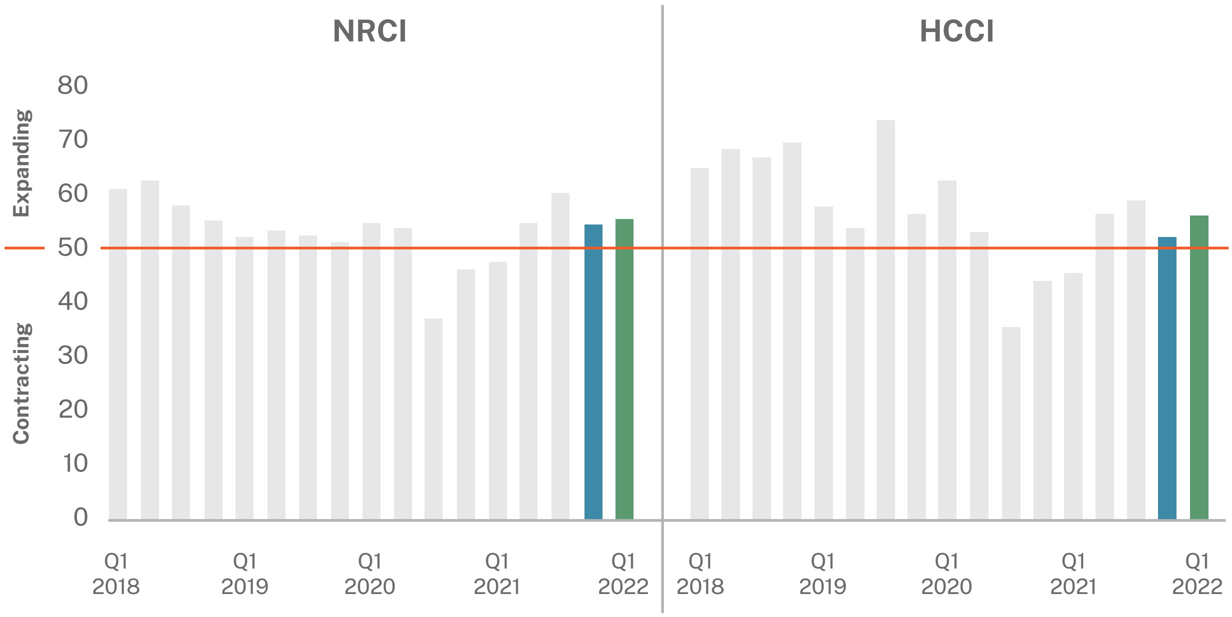
5 "2021 North American Engineering and Construction Outlook: Fourth Quarter Edition." FMI Corporation. Nov. 2021.

6 "2021 Heavy Civil Construction Index: Fourth Quarter Edition." FMI Corporation. Nov. 2021.

Figure 2: The Nonresidential Construction Index (NRCI)

Figure 3: Heavy Civil Construction Index (HCCI)



Source: FMI

Previous reading

Current reading

KEY DRIVERS

- I Federal Funding
- II Strong Housing Market
- III Focus on Sustainability

I Baseline Road Funding Will Increase Significantly

The $1.2 trillion IIJA will provide a significant increase in funding above the FAST Act baseline[7] for highway and streets beginning in 2022 and continuing for the next five years. The increased range of 30-55% depends on when certain funds are allocated; however, the bottom line is clear: "This bill represents a once-in-a-generation investment in the country's transportation networks," said National Asphalt Paving Association President and CEO Audrey Copeland.[8]

Guaranteeing funding for the next five or more years is excellent news for the near-insolvent Highway Trust Fund (HTF), which is funded by gas tax revenue. Investment in transportation will help fulfill the estimated $800 billion backlog of road and bridge capital needs.[9]

Across new and existing programs, the DOT will manage a large portion of the funds, which will funnel through to aggregates, asphalt and ready-mixed concrete producers. Federal agencies have expressed a desire to channel more funding toward repair and maintenance work. As a reference, under the FAST Act, states spent approximately 46% of funds on repair and reconstruction, and 19% on improvements to existing infrastructure (with the remaining funds going to new expansions).[10] Hot-mix asphalt producers will especially benefit from the focus on repair and maintenance, as the industry thrives on "shovel-ready," "mill and fill" repair projects.

In addition to traditional infrastructure segments such as roads and bridges, CM producers will also benefit from IIJA funding for power, water, environmental remediation and broadband projects, although to a lesser degree. The "small print" of the IIJA is also favorable for CM producers, as it provides some needed exemptions from Buy America rules and leaves out pavement mandates and Green New Deal language.

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7 Increase calculated from funding levels under the FAST Act.

8 "NAPA Applauds U.S. House Passage of IIJA." National Asphalt Paving Association. Nov. 6, 2022.

9 "ASCE's 2021 Infrastructure Report Card: Roads." ASCE. 2021.

10 Lombardo, J. "2022 State of the Road Building Industry." Asphalt Contractor. 2021.

II Housing Market Will Continue to Boost Demand

Residential construction is sensitive to changes in economic conditions, leading people to question whether we are experiencing a residential "bubble." FMI believes the current landscape indicates continued growth rather than the need for a correction. Low interest rates, an imbalance of supply and demand and the wave of millennials are all arguments against current activity being deemed a bubble.

Millennials, who have long delayed home ownership, now account for half of all purchases across the country and are driving home prices to record levels.[11] We see evidence that pent-up demand and tight housing inventory will continue to support a strong market.

The current pace of housing starts still pales in comparison to historic levels.[12] **Housing starts increased 16.8% to a seasonally adjusted annual rate of 1.679 million in November 2021, still well below the 2.14 million starts in 2005/2006.**

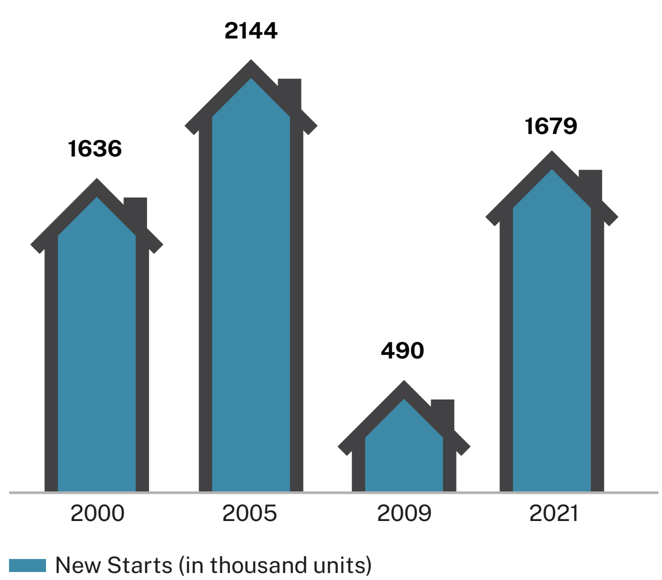
"This isn't a new boom cycle of new construction so much as it's an attempt to get even from the last bust," Zillow senior economist Jeff Tucker put it.[13] The coming years could see "record-high levels of demand," Ryan Dobratz, co-lead portfolio manager of the Third Avenue Real Estate Value Fund, told The Wall Street Journal.

"The NAHB expects the residential construction industry to continue to expand in 2022, despite significant headwinds, including a lack of building materials and a growing labor shortage," Robert Dietz, senior vice president and chief economist at the National Association of Home Builders, told FMI.

The NAHB has forecast single-family starts to end 2022 around 25% higher than pre-pandemic levels at end of 2019.

FMI is very bullish on residential and the light nonresidential construction that follows. From driveways to sidewalks and foundations, Construction Materials can expect strong demand.

Figure 4: 2021 New Housing Starts Have a Long Way to Go Before They Reach Pre-Great Recession Levels



Source: U.S. Census Bureau

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[11] Friedman, N. "Millennials Are Supercharging the Housing Market." Wall Street Journal. Dec. 14, 2021.

[12] Friedman, N. "U.S. Housing Market Is Nearly 4 Million Homes Short of Buyer Demand." Wall Street Journal. Apr. 15, 2021.

[13] "Home Builders Are Still Playing Catchup During Construction Boom." Zillow. Dec 3, 2021.

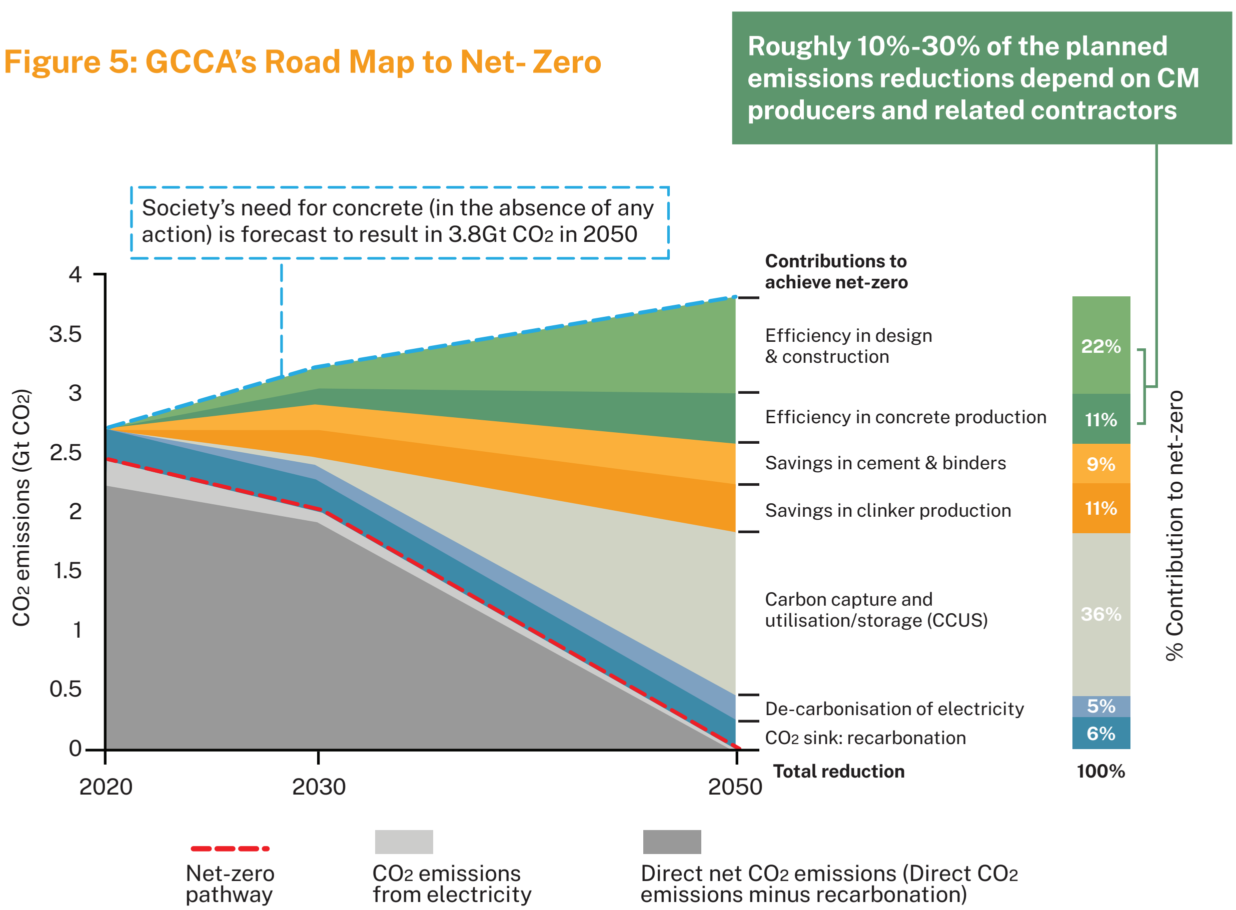
Sustainable Construction Will Be Incentivized

Government contracts are increasingly incentivizing green operations, as we saw from a wave of investment in green capital expansion projects through 2021. Furthermore, public companies are feeling the pressure to pursue green initiatives and are being rewarded for these efforts in the financial markets. We expect the push for "green" operations, such as recycling yards, will present attractive M&A opportunities moving forward.

In the past year, Holcim announced a $539 million investment in carbon capture, recycling and other green Capex projects. GCC, among others, has announced plans to convert a cement plant to Portland Limestone Cement (PLC), "a high-quality cement that lowers the carbon footprint." These specific business decisions are strategic and demonstrate a desire to stay ahead of the curve and capitalize on future funds earmarked for companies that can mitigate carbon emissions.

In 2020, members of the Global Cement and Concrete Association (GCCA) committed to net-zero carbon in concrete by 2050.[14] Measures include carbon capture and storage, alternate fuel sourcing and a reduction in waste through recycling. The outsized share of carbon emissions that buildings contribute makes this a crucial issue for construction firms.

Figure 5: GCCA's Road Map to Net- Zero



Source: GCCA

[14] "The GCCA 2050 Cement and Concrete Industry Roadmap for Net Zero Concrete." Global Concrete and Cement Association. n.d.

POTENTIAL HEADWINDS

- I Labor
- II Inflation
- III Pandemic Inefficiencies

I

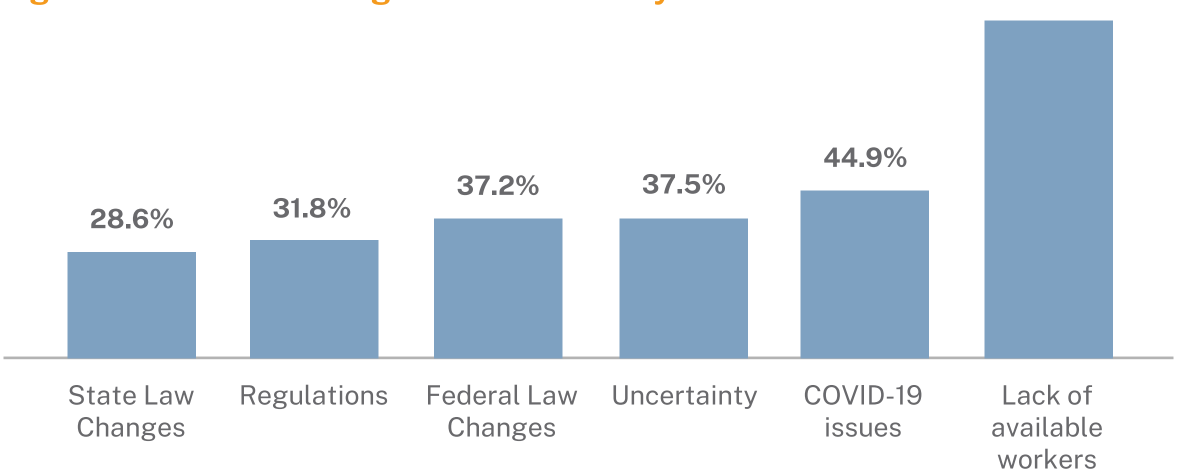
Labor Will Tighten as Spending Expands

We have been talking about the "war on talent" in our industry for over a decade now, having lost a generation of early- and mid-career workers during the Great Recession. While growth is good for the industry, the paradox of increased construction spending and a tighter labor market[15] will be a true challenge for some firms.

There is no simple fix for this problem. "Even if every one of the nearly 7 million unemployed people took an open job, there would still not be enough people in the labor market to fill these open roles," as stated in the LaborIQ 2022 Job Market Outlook.[16]

While CM plant facilities have been able to use automation and increased shifts to boost production, transportation and construction require skilled crews and drivers, which are in short supply. Firms that cannot access enough skilled labor will see constrained growth.

Figure 6: Factors Limiting Economic Activity



Source: U.S. Chamber of Commerce, June 2021

Wage increases may help with recruitment and retention—particularly long-term incentivization[17] — but FMI research shows that employees stay loyal when they feel a sense of connection to their work. Best-in-class firms achieve this through investing in talent acquisition, development and retention programs and by helping map the future for their people.

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15 "Construction Spending and Employment: History and Forecast Terms and Sources." Associated Builders and Contractors. 2021.

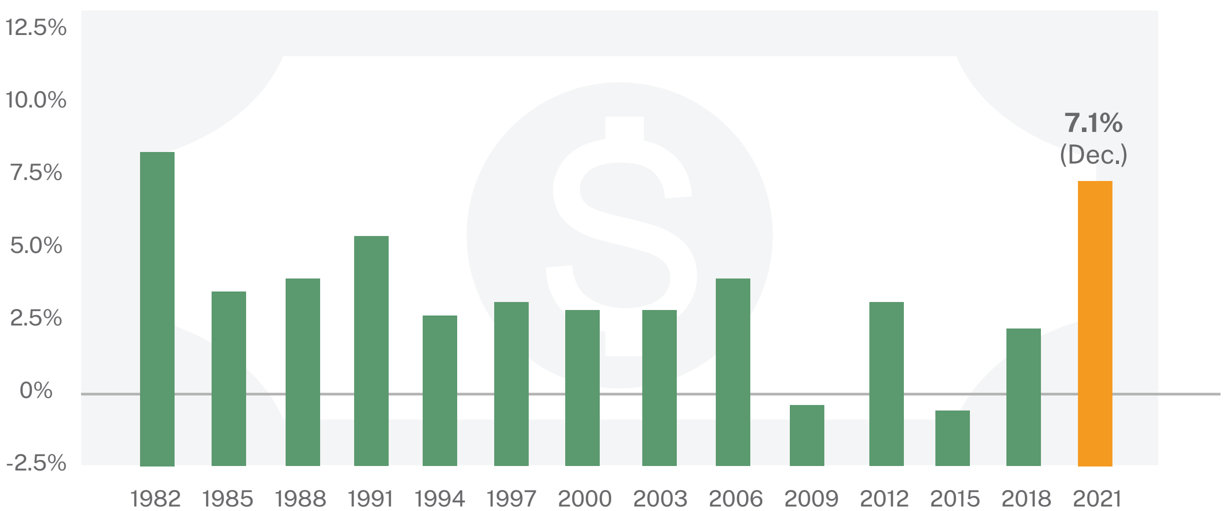
16 Schultz, B. "Labor Shortage Could Be 2022's Biggest Barrier to Construction Growth." For Construction Pros. Jan. 3, 2022.

17 Kapila, P. "Bringing Employees to the Table: Using Compensation to Achieve Successful Ownership Transfer." FMI Corporation. June 2021.

Inflation

The Consumer Price Index (CPI) hit 7.0% in 2021,[18] the highest level in 40 years and well above the Fed's desired boundary. Inflation issues remain uncertain, but CM firms have shown resilience. In the face of cost increases for labor, fuel and parts, many CM companies have been able to pass along expenses to customers and maintain margins. However, price increases typically lag in periods of rapidly increasing input costs. CEMEX cited a 34% year-over-year increase in cement import costs and a 19% rise in energy costs as a significant drag. However, the company was able to institute a second round of price increases in 2021 for the first time in over a decade and has plans for two more price increases in 2022.[19]

Figure 7: Energy, Labor and Input Price Hikes Push Inflation to a Nearly 40-Year High



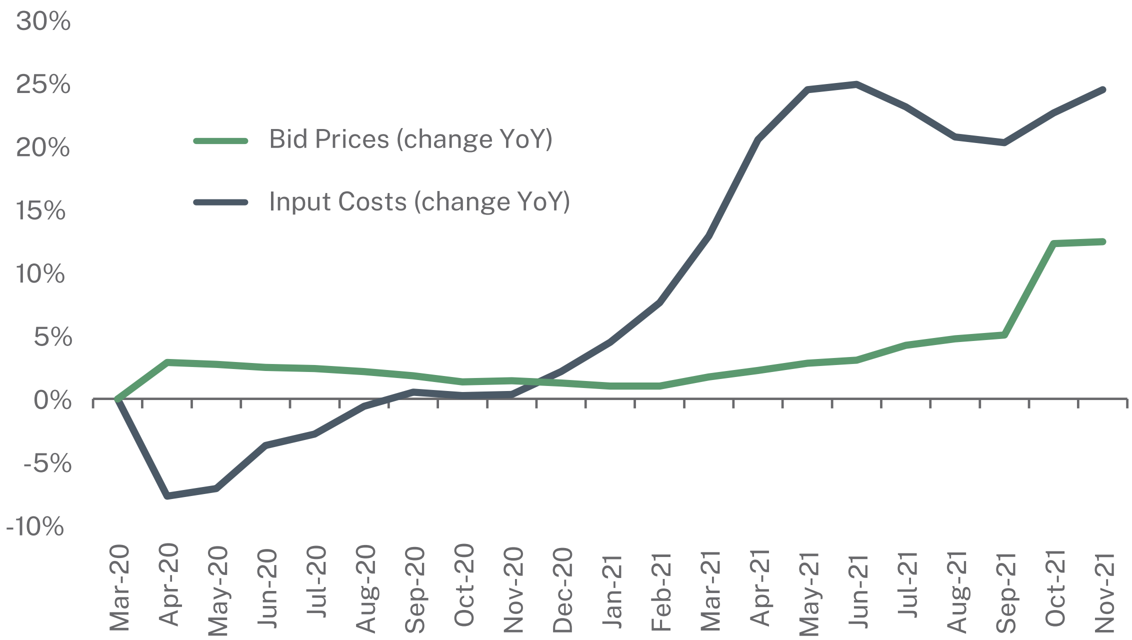
Source: U.S. Bureau of Labor Statistics

Whether firms benefited from or felt the crunch of inflation came down to cost structure and pricing power through the supply chain. Firms with strong market positions and efficient operations are poised to fare better in an inflationary cycle. Price pressures for energy, cement inputs, liquid asphalt and labor will all remain a challenge for CM firms in 2022.

[18] "Consumer Price Index Summary." U.S. Bureau of Labor Statistics. Dec. 10, 2021.

[19] "Third Quarter Results 2021." CEMEX. n.d.

Figure 8: Construction Firms Find it Harder to Pass on Price Hikes



Source: FMI, FRED

III Pandemic Inefficiencies

The Covid pandemic's primary impact on the CM sector has been the reliability and productivity of labor. For example, an entire paving crew can be shut down if one or more members tests positive. The ability to control transmission in the workplace will continue to impact projects in the foreseeable future.

MERGERS & ACQUISITIONS

The Mergers and Acquisitions Landscape

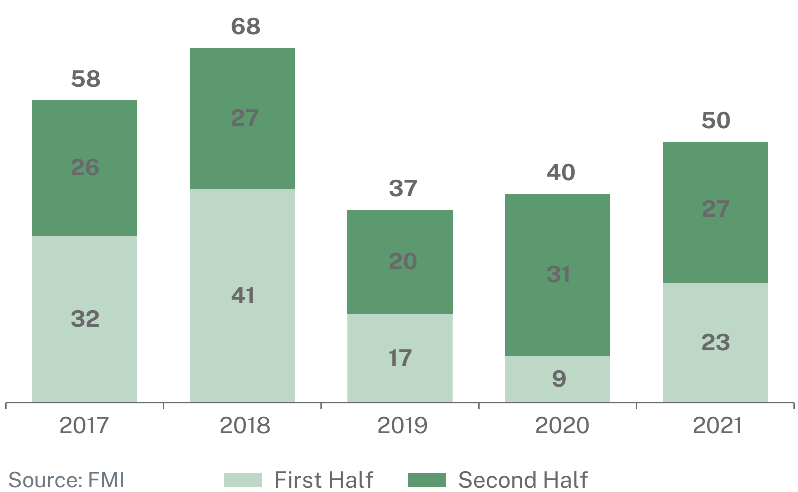
2021 presented an acquisition-rich environment for Construction Materials. Cash on hand, solid earnings and the labor challenge poised the industry for continued consolidation. This was illustrated by the two megadeals in 2021: Martin Marietta's purchase of Lehigh Hanson's West Region assets and Vulcan's acquisition of U.S. Concrete.

Going into 2022, we see twin tailwinds of cash-rich investors and prolonged government investment leading to further acquisitions across all three types of deals: bolt-on acquisitions, platform transactions and "thunderclap" consolidations.

Public markets are rewarding buyers for having more cash, less leverage and consistent high levels of EBITDA. These factors, combined with the continued residential boom and passage of the IIJA, have buyers eager to grow by pursuing mergers and acquisitions.

Figure 9: CM Deal Volume in H2 2021 Showed Strength in the Sector

There have been 50+ deals "announced" in the past 12 months, illustrating the recent trend in CM acquisitions.



Source: FMI

2017 and 2018:
M&A activity benefited from federal funding from the FAST Act.

2019:
Larger, public CM players lost substantial market cap in 2018, leading to lower deal volume in 2019.

H1 2020:
Sector experienced low deal volume due to COVID.

H2 2020 - 2021:
Deals have increased due to returned optimism.

2022:
M&A expected to continue at a bullish pace from federal funding.

CM leaders thinking about selling in the next few years should find an optimal market at this time. There are no dark clouds on the horizon right now, but further into the future the unknowns grow.

We advise sellers to leave some "bloom on the rose," which means to sell when things are going well rather than attempting to log more successful years and risk losing momentum or buyer appetite. The synergies that drive many deals can depend on timing—and good timing for deals can pass quickly. The bottleneck on the buyer side is not capital but limited resources to handle so many deals, the result of which is a tight focus on very strategic deals.

Conclusions

The stars have aligned, with a historic infrastructure bill, decades of underinvestment in the nation's roads and bridges, and an ongoing boom in the residential sector all contributing to strong demand for CM.

A once-in-a-generation federal investment is a windfall for CM producers across aggregates, asphalt and ready-mixed concrete, but the sheer uptick in demand will challenge an industry beset by labor shortages. As funds begin to come down the chute, firms' ability to capitalize will depend in part on their talent development and retention strategy and on their alignment within the industry. Buyers will have fresh motivation to grow via M&A—it is more efficient to acquire people than to grow an organization organically.

In the CM industry, of course, sell decisions are complex and often intensely personal when concerning a family-run business, so a deal needs to be right. A prolonged period of federal investment has the potential to catalyze changes in the industry, especially as firms steer through shorter-term inflation, interest rate hikes and supply chain challenges. As in any period of turbulence—good or bad—those with a solid strategy will fare best. The 2022 outlook is very good indeed for CM, but the challenge is now on CM firms to decide how to take advantage of the moment.

ABOUT THE AUTHORS

East Coverage

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FMI Capital Advisors

FMI Capital Advisors specializes in sell-side mergers and acquisitions for the construction materials industry.

With **100-plus** completed transactions in the Construction Materials sector, FMI's team brings value through extensive industry relationships and deep market knowledge of the built environment.

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has been acquired by
CRH
FMI Capital Advisors
SELL-SIDE ADVISOR

KUHLMAN
has been acquired by
THE GERKEN COMPANIES
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JSL ASPHALT INC.
has been acquired by
PECKHAM INDUSTRIES, INC.
FMI Capital Advisors
The undersigned served as the exclusive financial advisor to JSL Asphalt, Inc.

John S. Lane & Son, Inc.
TRAP LANE ROCK
has been acquired by
PECKHAM INDUSTRIES, INC.
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The undersigned served as the exclusive financial advisor to John S. Lane & Son, Inc.

Myr & Roy's Paving, Inc.
has been acquired by
L. G. EVERIST, INC.
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SELL-SIDE ADVISOR

SCC materials
a subsidiary of
webber
has been acquired by
Martin Marietta
FMI Capital Advisors
SELL-SIDE ADVISOR

ACE READY MIX
has been acquired by
L. G. EVERIST, INC.
FMI Capital Advisors
SELL-SIDE ADVISOR

PALMER PAVING CORP
has been acquired by
PECKHAM INDUSTRIES, INC.
FMI Capital Advisors
The undersigned served as the exclusive financial advisor to Palmer Paving Corporation

McCARTNEY CONSTRUCTION CO. INC.
has been acquired by
Vulcan Materials Company
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