The Powerful Recovery in Non-Residential Construction Spending

*Alger Senior Industrials Analyst **Alex Goldman** discusses capital depoloyment, and the ongoing recovery in residential housing and non-residential construction.*

Alex Goldman: I will be providing some of our updated thoughts and observations on the industrial space, and highlighting themes within the industry that we are most excited about, looking forward. The themes that we're most positive on at this point fit squarely into broader Alger investment philosophy of looking at the companies that can generate high unit growth or are exposed to meaningful life cycle change. Many of these have been highlighted in broader commentary by our PMs.

Nevertheless, I'll be providing some incremental details. Among the themes that we like at this point are recovering domestic nonresidential construction; recovering residential housing in the U.S.; and capital deployment, especially at the firms that we consider to be platform companies that we believe have strong existing franchises and can integrate assets well.

So, going through these in greater detail, nonresidential construction has been an area of focus for us for over 18 months. We believe domestic nonresidential spending has meaningful upside in the coming years. Recovery in this market has lagged the broader domestic economy. In the past twelve months, spending on nonresidential construction was equal to roughly 3.5% of GDP. Long-term history suggests that normalized spending levels should be in the 4.0-4.5% of GDP. For the 1993 to 2010 period, the average was 4.2%. Recovery to that level of spending relative to current GDP would imply an incremental $124 billion dollars of spending or roughly 22% growth without assumption of any growth in GDP.

Looking at it differently, McGraw-Hill estimated that in 2014, the U.S. added about 950 million square feet of nonresidential space, which compares to an average for the 1967 to 2014 period of close to 1.3 million square feet. Thus, using history as a guide implies that activity in this market is more than 30% below historic norms. Importantly, our fundamental channel checks strongly support this theme across a number of sub-segments, including aggregates, cement producers, lighting companies, security, HVAC, etc. Especially in the past three to sixth months, we've been hearing of stronger and broader recovery in nonresidential construction vertical.

Another theme that we like a lot at this point is the recovery in domestic housing. In 2014, housings starts were just over one million units in the U.S. That compares to a 55-year average of close to 1.5 million units. Thus, there is roughly 50% upside from current levels just to get back to a very long-term trend. Also, it is important to know that residential construction has been running below historic average for the past seven years. Not only has that absorbed the excess building from the prior cycle, but has also likely created meaningful pent-up demand.

There are still meaningful headwinds to a more vibrant recovery in residential construction. Mortgage availability, while marginally easing, remains relatively constrained. Ability of the first time homebuyers to purchase a home and qualify for a mortgage also remains a headwind. However, we see cyclical trends providing meaningful tailwinds to this market, which should drive a continued recovery. Most important is that we're seeing household formation and consumer disposable income picking up. Both drivers are leading to increasing appetite for home purchases and repair/remodel activity.

Home prices troughed in 2011, and have seen a consistent recovery since. Aside from making consumers feel better about one of their largest investments, this trend has dramatically reduced the level of negative mortgage equity. At the end of 2014, roughly 11% of mortgaged homes in the U.S. had negative equity. That compares to 26% in 2010. This materially increases the pool of potential buyers going forward. Our industry channel checks are clearly showing solid consumer interest in housing. Homebuilders are reporting stronger consumer traffic and order conversions.

As it relates to the repair and remodel, we would note that consumer spending on residential properties has been running at 3.0-3.5% of GDP. That compares to an average of 4.7% for the past 65 years. Looking at it differently going back to 1950, recessionary spending on residential properties troughed at 3.2%-3.9% of GDP. Thus, spending in this market is running around the levels that established a recessionary bottom going back to 1950.

Capital deployment is another important theme for industrials. A number of our companies have a substantial amount of excess capital. Given the extremely low level of interest rates, deploying this capital either through acquisitions or stock buybacks becomes very accretive to earnings. Many management teams are clearly focused on this.

One of the largest companies that we cover currently has essentially no net debt, while its earnings and free cash flow are continuing to grow. This company has a strong global franchise and is managed by a well-regarded management team. As a result, as we've highlighted in the past, companies that fit this criteria have a strong platform to make accretive acquisitions.

As we look at the themes that we're most excited about going forward, the companies that we focus on the most are the ones that can outgrow their respective end-markets. So, for example, I mentioned aggregates as one of the areas that we have been excited about over the past six to nine months.

Aggregates are essentially stones or pebbles, however you want to define it; that are used in construction of roads, various infrastructure projects. Any type of residential or nonresidential construction typically involves some use of aggregates, as they form a foundation for the structure. Within aggregates, we're basically seeing ability of the producers to capitalize not just on the volume recovery in the underlying market, but also accelerating pricing power for the actual material. That should allow these companies to dramatically outgrow many of their peers. We like some of the aggregates producers more than others because of their cost structure, level of restructuring that's been done from the prior cycle, and the quality of their management team.

Another example would be companies that participate in adoption of LED lighting. LED lighting benefits from broader recovery in nonresidential construction, and then on top of that, there is a secular penetration story that should allow these companies to outgrow whatever the broader macro trends give them.

There's continued focus on energy efficiency throughout nonresidential structures. So we cover, talk to, and own a number of HVAC system manufacturers. But they're benefiting from essentially this trend of property managers looking at their existing facilities and thinking about ways of how they can make the infrastructure more energy-efficient. And the developments within the HVAC space are giving them plenty of options to think about, such as how they can modify existing infrastructure to improve energy efficiency and cut operating costs, going forward.

A decline in the price of oil and broadly in petrochemicals has had a pretty meaningful impact to the industrial space, from a number of different verticals. Companies are benefiting from a decline of their raw material feed stocks.

When we think about companies that are exposed to the domestic consumer, those definitely benefit from a reduction in fuel prices. The domestic economy is strongly levered to the domestic consumer, and consumers certainly benefit when the price of gasoline goes from $3.50 a gallon to just over $2.00. It gives them more disposable income, which ultimately leads to greater demand for a broad variety of things.
I will conclude there. Thank you for your time, and your continued interest in Fred Alger Management.
