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OUTLOOK

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Building Materials – US

Update: Revising outlook to stable amid maturing construction cycle

» **We are revising our outlook to stable from positive.** This change to stable reflects our expectations of slower organic operating income growth over the next 18 months due to diminishing demand in private construction. We expect organic operating income growth for the building materials companies that we rate will decelerate in 2019 to an annualized pace below 7%, following four years of strong growth. Our forecast is at the high end of the -3% to +7% operating income growth range for a stable outlook and incorporates more modest, but still growing construction spending.

» **Private residential construction growth is decelerating, with several key factors pointing to a slowdown.** Rising mortgage rates and a decline in housing affordability have led to a spike in new home inventory and support Moody's stable homebuilding outlook. We expect single-family housing starts to grow 4.5% in 2018 and 3.2% in 2019, compared with 9%-10% average growth from 2015-2017. The inventory of new, unsold homes reached seven months for the first time since 2011. Multifamily rental housing construction has experienced weak growth since 2016, in large part due to reduced capital availability. Multifamily housing starts are expected to grow 7.6% in 2018 and 2.4% in 2019. While that is an improvement from the 11% decline during 2017, those figures are still weak by historical standards. The overall residential construction sector is also facing labor constraints and increasing raw material costs. We expect private residential housing demand to remain stable, supported by solid wage and job growth, low unemployment and millennials' growing need for housing.

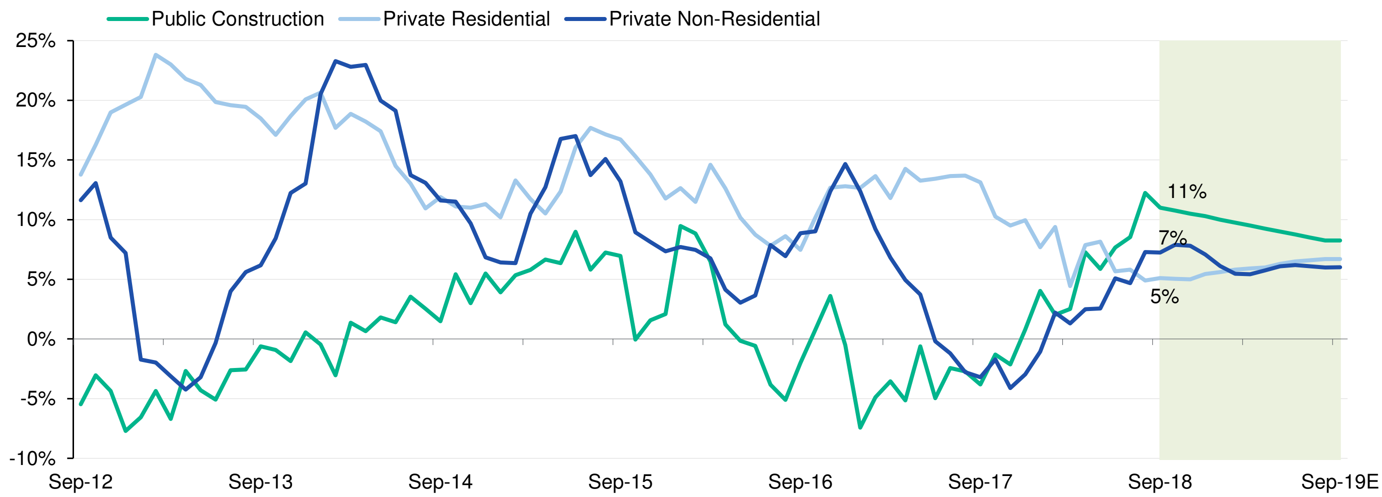
» **Private non-residential construction spending will also see slower growth in 2019.** Non-residential construction should grow 4% in 2019, with the predominance of activity being generated by industrial and institutional construction, according to the American Institute of Architects' consensus construction forecast. This forecast shows slowing commercial building construction and is lower than expectations of 4.7% growth in 2018. Again, labor constraints, as well as the high cost of materials and land, support our stable view for private non-residential construction over the next 12-18 months.

» **Public infrastructure spending remains robust, particularly at the state level.** Construction spending in the public sector has grown since late 2017 and reached 11% year-over-year growth as of September 2018 (see Exhibit 1). We expect continued, albeit somewhat slower, growth in 2019 of 8% as states continue to pass new long-term legislation supporting highway construction. For example in November 2018 California voters recently rejected a repeal of SB1, a gas tax increase passed in 2017 to help pay for highway infrastructure throughout the state. At the federal level the Fixing America's Surface Transportation (FAST) Act provides funding through 2020 for public infrastructure, close to 75% of which is allocated to the Federal Highway Administration. We remain cautious on public infrastructure spending growth beyond 2020, particularly at the federal level, as other agenda items will likely take priority during an election year.

Exhibit 1

Public construction spending growth expected to outpace private construction spending growth

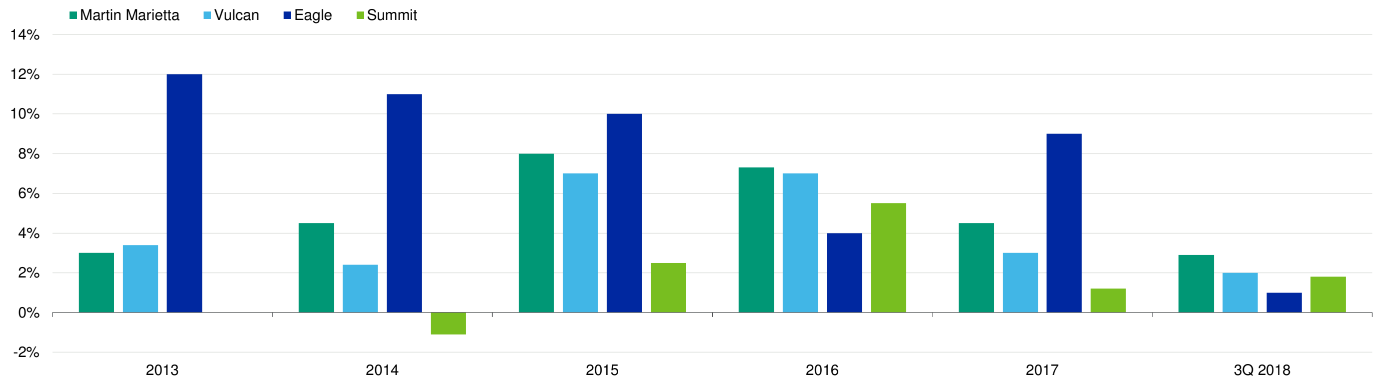
Total construction put in place (YoY change)



Source: Factset and Moody's Investors Service

» **Price increases have largely moderated, but remain positive.** Building material companies' ability to increase prices across all products has diminished in 2018, and is another indicator of tempering in the sector. Aggregates pricing growth is currently in the low single digits (see Exhibit 2). On the positive side, pricing and volume growth is helping to offset labor constraints and higher material costs on margins. In addition, the rated building material companies continue to report strong backlogs, despite weaker earnings in 2017 and 2018 due to the weather.

Exhibit 2
Pricing growth has largely moderated, but remains positive
Aggregates YoY change

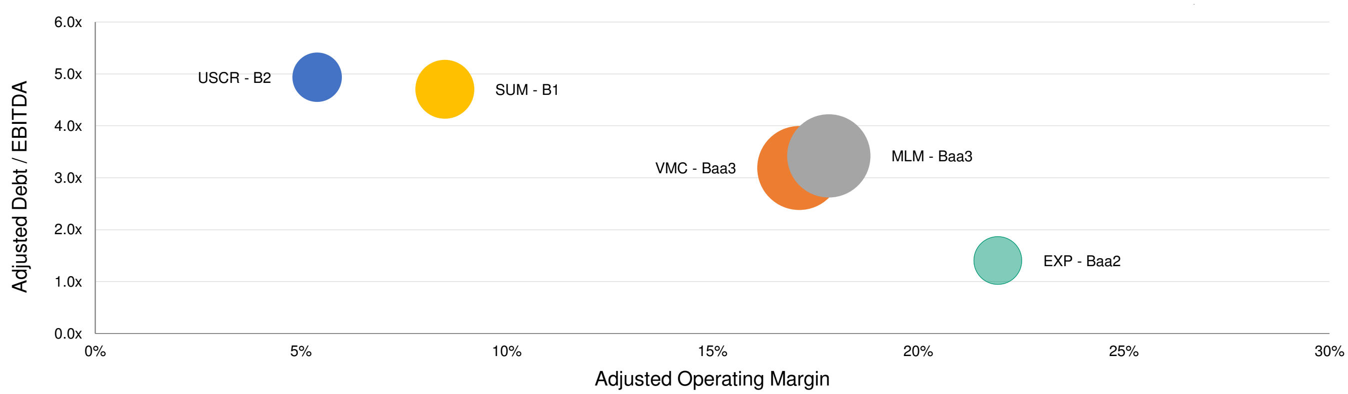


Source: Company filings

» **Product mix continues to shift towards aggregates.** Several rated building materials companies have either increased their percentage of revenues coming from aggregates or recently made a major acquisitions in the aggregates space, including: Vulcan Materials Company (Baa3 stable), Martin Marietta Materials, Inc. (Baa3 negative) and U.S. Concrete, Inc. (B2 stable). Restrictive permitting processes in most metropolitan areas and high transportation costs makes the aggregates industry very regional in nature and limit competition. Accordingly, aggregates producers benefit from better pricing power through cycles, compared to sellers of cement and ready-mix concrete.

» **Solid credit metrics and strong liquidity help mitigate volatility in earnings.** The rated US building material companies have good credit profiles, with leverage that has generally trended down over the last decade. Internal liquidity is strong, with minimal near-term maturities, high levels of cash and line availability. Furthermore, the building material companies have strong cash flow generation, with a demonstrated ability to generate positive cash flows during economic downturns.

Exhibit 3
Solid credit profiles support current credit ratings
Moody's adjusted debt/EBITDA and operating margins



Peer comparative includes Eagle Materials Inc. (EXP), Martin Marietta Materials, Inc. (MLM), Summit Materials, LLC (SUM), U.S. Concrete, Inc. (USCR) and Vulcan Materials Company (VMC)
Source: Moody's Investors Service

» **What could change our outlook?** We could revise our outlook back to positive if the industry's organic operating income growth increases above 7%, coupled with continued solid momentum in public, private residential and private non-residential construction as well as stable federal highway spending. Our outlook could change to negative if the industry's organic operating income contracts by 3% or more, there is a reversal in end market momentum and/or there is a reversal of broader economic indicators pointing to recessionary conditions.

Since outlooks represent our forward-looking view on business conditions that factor into our ratings, a negative (positive) outlook suggests that negative (positive) rating actions are more likely on average. However, the industry outlook does not represent a sum of upgrades, downgrades or ratings under review, or an average of rating outlooks of issuers in the industry, but rather our assessment of the main direction of business fundamentals within the overall industry.

Moody's related publications

» Homebuilding - US Outlook: Slower growth, increasing headwinds, prompt outlook cut to stable from positive, November 2018

» Building Materials — US: Positive outlook supported by strength in construction spending, producer optimism, June 2018

» Building Materials - Global: Energy-intensive cement makers facing rising pressure to lower carbon emissions, July 2018

» Cross-Sector - US: Next Congress is unlikely to change direction of US policy, November 2018

» State government - US: Four issues that will determine the credit impact of November's elections for states, October 2018

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