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Utility & Communications

Construction Outlook

The utility transmission and distribution, and communication distribution industries remain in a multiyear investment cycle driven by the need to repair, replace and upgrade the transmission and distribution infrastructure across the United States. Couple this investment with growing demand for broadband network speed and an aging investor-owned utility workforce, and there are robust long-term tailwinds that will continue to drive growth for third-party construction companies.

FMI projects with capital expenditures will remain over $100 billion for U.S. investor-owned utilities, which is down from the 2016 peak and similar to the investments in 2017. However, the capex reduction is primarily related to generation investments. FMI anticipates continued capex growth on power and gas transmission and distribution infrastructure. Some of the largest spending programs in 2018 are to either replace aged infrastructure or to harden the power network by taking overhead infrastructure and burying those lines underground.

In addition, the proliferation of distributed energy resources (DERs) is requiring utilities to undergo smart grid initiatives, including installation of smart meters and communication technology that provide insight into the two-way flow of power. These programs are in their infancy and will continue over the next 25-30 years as the Department of Energy, state utility commissions and utility providers adapt to a rapidly changing generation environment.

As the underground construction industry has continued to grow, limitations and risk factors are present that could impact sector performance. The most significant is the demand for labor to complete the work opportunities that exist. Multiple initiatives are ongoing across the industry to recruit and develop the workforce, and individual companies have expanded their own internal training plans. However, training and development of people takes time and could impact industry growth.

Federal policy is expected to remain favorable with the Trump administration, but many questions remain. The EPA is reviewing the Clean Power Plan, multiple interstate pipeline projects are in flux and power reliability requirements could impact renewable construction. Lastly, as the federal reserve increases rates, the cost of borrowing goes up, as does the cost to finance necessary projects. The low cost of natural gas and improved power efficiency have kept utility bills at reasonable levels, but increased project costs could face pushback from consumers and slow down investment.

Power distribution

Electric distribution networks are in need of substantial investment. The assets and technology that represent the backbone of America's electric infrastructure were put in place in the 1950s and are near the end of their life cycle. An estimated 45 percent of electric distribution assets either currently, or will soon, need replacement due to reliability concerns.

After the recent expenditures on the electrical transmission network, the largest funding gap is in the electric distribution network. Current spending is inadequate to meet the growing needs for reliability and capacity. The funding gap will widen if additional investments are required to meet growth in local distribution networks or faster implementation of smart grid technology.

To address these concerns, a number of large rate-case decisions will be made by utility commissions to increase the amount allotted to maintenance of distribution networks across the U.S. in 2018.

Natural gas transmission and distribution

The outlook for natural gas transmission and distribution contractors is very strong. Demand for natural gas has increased in electric power generation, industrial use, exports and residential heating. Natural gas-fired power plants are the primary source of new utility-scale generating capacity. To accommodate this growth, companies have had to repurpose or reverse existing pipelines and laterals to gas-fired generators, build new pipelines and increase storage infrastructure.

The natural gas infrastructure is still in the midst of rapid expansion of its gas processing capacity, as well. Natural gas is now the primary fuel or power generation in the U.S. and over 25 million GW of generating capacity will come online in 2018. U.S. natural gas processing capacity is expected to increase across the country through 2030, as utilities and manufacturers take advantage of the low-cost natural resource.

The gas industry spent billions expanding the pipeline network to transport gas to processing facilities, but significant work remains. The price differential between two points creates an incentive for shippers to support midstream pipeline development to capture the pricing advantage in the network. This occurs in instances where new production must travel via interstate pipeline to reach demand centers, utilization is high and capacity is maximized. This is the case in the Marcellus Shale Formation, located across states in Northern Appalachia, where new transmission pipeline construction is active and expected to continue.

For the gas distribution contractor, North American local distribution companies are at the front end of a 20- to 30-year replacement program to address aging infrastructure. PHMSA oversees almost 2.2 million natural gas main and service miles of which almost 30 percent is "leak-prone." Unlike other utility products, the combustible nature of gas does not allow for poor maintenance and inspection practices.

Approximately 60 percent of the U.S. gas distribution network was built prior to 1970. The most leak-prone distribution pipeline material is cast iron, which still represents approximately 3 percent of gas mains in the U.S. Bare steel is the second most leak-prone material and represents 4 to 5 percent of gas mains in the U.S. Using estimates from the American Gas Association and PHMSA data, the cost to replace leak-prone pipe in the United States is still greater than $300 billion.

Communications infrastructure

The demand for bandwidth continues to grow at an exponential rate. Cisco estimates that North American Petabytes per month will grow at a compound annual growth rate (CAGR) of 20 percent over the next five years. In the same period, mobile data and internet traffic is expected to grow at 34 percent CAGR. One GigaBits Per Second (GBPS) standards have emerged across the United States and the incumbent players are being driven forward by companies like Google and even progressive municipalities.

A $130 billion to $150 billion fiber infrastructure investment is required in the U.S. to unleash innovation, close the digital divide, and fully prepare the country for 5G, according to a report from management consulting firm Deloitte. The capex projections by the largest carriers appear to support that investment, and will drive growth in the communications segment if contractors find the people to execute the work.

Municipal water/wastewater

Sewage and waste disposal construction put-in-place was down 11 percent in 2017. Similarly, water supply spending was down 8 percent and declines of 3 to 4 percent in spending are expected across both segments in 2018. Local governments are caught in an unsustainable financial situation resulting from eliminated or reduced federal assistance, but maintained mandates and regulations. Spending is directed at compliance and there are limited funds to perform new builds and improve the water supply in areas that desperately need it.

In addition, the EPA has had an air of uncertainty regarding Trump administration decisions. Limited guidance makes it difficult to plan for water systems that will be in place for a very long time. The estimates for what is necessary to take water infrastructure and funding to an adequate place vary widely, but the American Water Works Association puts the value at nearly $1 trillion. The rate-based systems of recovery will fall short.

Utility & Communications Construction Index

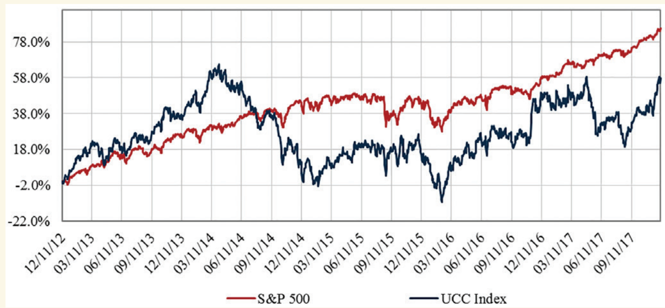
The Utility & Communications Construction Index (UCC Index) presented below presents the performance of the sector's publicly traded stocks over the past three months (Figure 1), past year (Figure 2) and the past five years (Figure 3).

The UCC Index companies have significantly outperformed the S&P 500 companies over the past three months. Earnings beat projections across some of the largest players, and the 2018 outlook is strong. Additionally, merger and acquisition activity, including the acquisition of Canadian companies Aecon and NAPEC, impacted valuations and price expectations for the UCC companies.

The UCC Index paints a slightly less rosy story over the past year. As the trading public realized a grand infrastructure deal from the Trump administration was not in the works for 2018, the sector saw a decline back to pre-election levels. Anticipation for a strong 2018, driven by industry fundamentals. guided the recovery over the past three months.

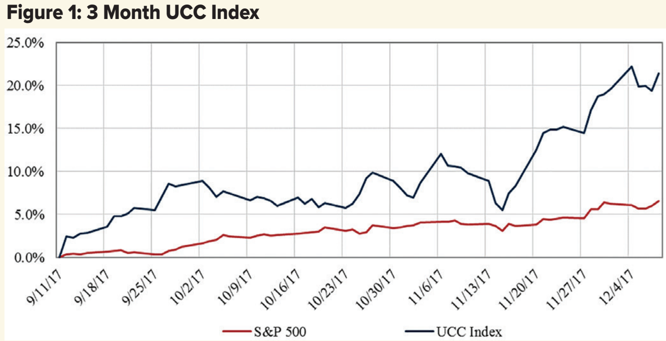
The five-year picture demonstrates the reliance of underground con-

Figure 3: 5 Year UCC Index



Source: FMI Research, S&P Capital IQ; as of December 8, 2017

Figure 1: 3 Month UCC Index



Source: FMI Research, S&P Capital IQ; as of December 8, 2017

Figure 2: 1 Year UCC Index

Source: FMI Research, S&P Capital IQ; as of December 8, 2017 struction on oil and gas. As pricing fell in the summer of 2014, the value of companies in the UCC Index declined. While we anticipate this trend to decline as the communications industry grows and more power lines are moved underground, the UCC companies will continue to be impacted by the price of oil.

As we look at performance across the UCC Index, the companies seeing the most improvement have connections to materials and the communication segment. Poor operating performance from select companies decreases the mean UCC Index values, and we view the median as a better proxy for average operating performance this quarter. EBITDA from the index is nearing an all-time high and year-end expectations are strong due to increased oil and gas opportunities, backlog and good execution from the major players.

The UCC Index companies' trading metrics have improved throughout the quarter. In particular, Dycom and MDU are seeing a strong resurgence in the market driven by good operating performance and underlying industry dynamics. Median values are the best proxy again due to outsized multiples from select companies in the UCC Index.

The fourth quarter of 2018 was punctuated with some large transactions that will impact the market landscape for many years to come. Interestingly, the two largest transactions occurred with our Canadian neighbors. First, CCCC International acquired Aecon Group for approximately $991 million USD. CCCC International is the financing platform for overseas businesses of China Communications Construction Company Limited, currently the third-largest international construction company in the world.

Aecon's infrastructure services group performs heavy civil, transportation infrastructure, and water and wastewater treatment facility construction. The transaction will grow CCCC's international presence and increase Aecon's ability to take up larger and more complex projects through a greater capital base.

The second significant acquisition is the purchase by Oaktree Capital Management's GFI Energy Group ("Oaktree") of one of the members of the UCC Index, NAPEC Inc. ("NAPEC"). NAPEC is publicly traded on the Toronto Stock Exchange and the offer by Oaktree represents a 35.4 percent premium to the closing price on December 1, 2017. The total transaction value of $320 million CAD includes the assumption of debt and creates an implied enterprise value of approximately $250 million USD. Oaktree seeks to leverage the network, financial resources and energy sector experience to grow its utility services in North America. We anticipate growth through acquisition and an expansion of both its U.S. and Canadian power operations.

Lastly, MYR, Emcor and Aegion have completed recent share buybacks, and multiple public companies have completed shelf offerings that would provide access to public funds for select purposes. This implies two things: first, public companies in the industry view their stock as undervalued and the purchase of the stock is a reasonable use of capital. Second, the cost of equity is low and public companies believe that they can use equity to grow their businesses through either green-fielding operations or acquisition.

Figure 3: UCC Index Companies' Operating Performance

Company	Enterprise Value (EV)	LTM Revenue	LTM EBITDA Margin %	LTM RoA %	LTM RoE %
MDU Resources Group, Inc.	7,199	4,294	14.6%	4.1%	10.2%
Quanta Services, Inc.	6,789	9,091	7.5%	4.8%	8.3%
MasTec, Inc.	5,170	6,346	9.6%	7.4%	20.9%
Dycom Industries, Inc.	4,114	3,024	12.9%	7.9%	20.7%
Primoris Services Corporation	1,546	2,403	7.3%	5.8%	13.1%
Aegion Corporation	1,163	1,343	9.2%	4.0%	-6.6%
MYR Group Inc.	675	1,373	5.4%	4.0%	5.9%
Matrix Service Company	453	1,126	1.9%	-0.1%	-1.6%
Layne Christensen Company	370	602	2.3%	-2.0%	-49.7%
NAPEC Inc.	246	341	7.6%	2.3%	1.2%
Willbros Group, Inc.	147	797	-4.1%	-8.3%	-55.8%
Mean			**6.7%**	**2.7%**	**-3.0%**
Median			**7.5%**	**4.0%**	**5.9%**

Source: S&P Capital IQ, data as of December 8, 2017; all data is TTM.

Figure 4: UCC Index Companies' Trading Metrics

Company	Enterprise Value (EV)	EV/ Revenue	EV/ EBITDA	EV/ EBIT	Price/ Book
MDU Resources Group, Inc.	7,199	1.7x	11.5x	17.3x	2.3x
Quanta Services, Inc.	6,789	0.7x	10.0x	14.5x	1.6x
MasTec, Inc.	5,170	0.8x	8.5x	12.1x	3.0x
Dycom Industries, Inc.	4,114	1.4x	10.6x	17.6x	4.9x
Primoris Services Corporation	1,546	0.6x	8.8x	14.0x	2.7x
Aegion Corporation	1,163	0.9x	9.4x	15.2x	1.8x
MYR Group Inc.	675	0.5x	9.0x	19.0x	2.2x
Matrix Service Company	453	0.4x	21.3x	-444.1x	1.4x
Layne Christensen Company	370	0.6x	27.2x	-26.4x	4.3x
NAPEC Inc.	246	0.7x	9.5x	32.9x	1.8x
Willbros Group, Inc.	147	0.2x	-4.5x	-2.8x	0.9x
Mean		**0.8x**	**11.0x**	**-30.1x**	**2.4x**
Median		**0.7x**	**9.5x**	**14.5x**	**2.2x**

Source: S&P Capital IQ, data as of December 8, 2017; all data is TTM.

Figure 5: Recent Deal Activity

Announced	Target	Acquirer	Business Description
12/04/2017	NAPEC Inc. (TSX: NPC)	Oaktree Capital Management	Power T&D
11/06/2017	New England Utility Constructors	Patterson-UTI Energy	Directional Drilling
11/03/2017	Infrastructure & Energy Alternatives	M III Corporation	Renewable Energy
10/26/2017	Aecon Group Inc.	CCCC International	Infrastructure, Energy and Mining
10/25/2017	O-Tex Pumping, LLC	C&J Energy Services	O&G Field Services
09/05/2017	Multi-Shot LLC	Patterson-UTI Energy	Directional Drilling