New Roads To Growth

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Once Donald Trump's upcoming growth plan for the United States begins to materialise, we see good opportunities for growth and expansion for companies with business models directed at the construction industry. There is both commitment and support from President-elect Donald Trump, Congress and the general population for addressing the huge need to improve US infrastructure.

Trump plans to employ extensive fiscal stimulus, partly through tax breaks and public investment. The coming president estimates that USD 500 million will be spent on a massive infrastructure expansion and restoration plan involving roads, tunnels, airports, railways, sewage and water systems, bridges and dikes. The proposed spend is double the amount Hillary Clinton promised in her presidential campaign. Trump also plans to reduce income taxes by more than 30 pct. and create at least 25 million new jobs, partly through infrastructure investment.

An even higher price tag

Every four years, the American Society of Civil Engineers releases a 'Report Card for America's Infrastructure'. The most recent report shows that US infrastructure is in poor shape and remains well below standard. Worn-down infrastructure can be dangerous and is a heavy expense for society, for example when longer transport times impact productivity. It will require an estimated USD 4,000 billion to repair and expand the worn-down US infrastructure and to upgrade it to contemporary standards.

There are also examples of ageing infrastructure in the public water supply. New water pipes to provide clean drinking water to schools and other public institutions will require an estimated investment of USD 1,000 billion. Many water pipes are more than 100 years old.

More than 600,000 bridges in the USA are in need of maintenance. The average age of US bridges is over 40 years. About ten percent of those bridges – some 60,000 – require extensive repairs or actual replacement.

The inland waterways play an important role in freight transport in the USA, and many locks and dikes are more than 50 years old. Some 14,000 of the country's 84,000 dams are in such poor shape that they pose a direct flooding hazard. Repairing them will cost an estimated USD 20 billion.

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As can be seen from Figures 1 and 2 on the following page, investment in US and European road networks declined by almost 30 percent between 2002 and 2013:

Figure 1

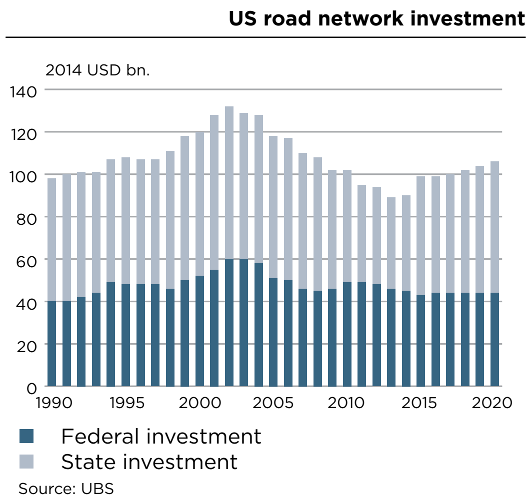
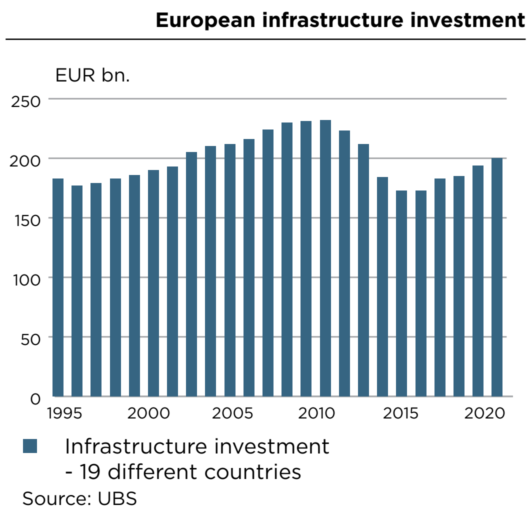


Figure 2



The moderate growth seen since 2013 has been driven mainly by government initiatives, and the long term rate of investment growth has declined. As a result, the general rate of earnings growth in the construction sector is currently well below previous cyclical peaks. This is an important parameter when evaluating companies in the industry as it can make them seem expensive in P/E terms. The reason is that the sector has not been part of in previous cyclical recoveries, and that will be reflected in the estimated earnings growth of companies in the sector.

Easier said than done

Improving and expanding infrastructure can be a complex task involving many different professions, heavy-duty machinery, difficult-to-transport materials and long-term planning and, as a result, often results in budget overruns. Consequently, such projects often require changes in plans, are subject to delays and feature the constant need to prioritise between achieving milestones and financial considerations.

That picture had already emerged in advance when EU Commission chairman Jean-Claude Juncker wanted initial funding of about EUR 20 billion for infrastructure in his European growth plan. By establishing the European Long-Term Investment Fund ("Eltif"), he aimed to attract EUR 315 billion from private and public sector investors over three years. Juncker has since had to change that capital requirement to EUR 630 billion.

Europe has generally not seen huge infrastructure budgets, and the same used to apply to the USA, as neither have had the desired degree of 'flexibility' in their national budgets. It now appears, however, that Trump has received positive indications from Congress regarding infrastructure investment, even though Congress has historically been opposed to setting up funds for investment purposes.

Funding?

Although there is a general agreement that Mr Trump's plan will generate growth in the construction sector, its funding and speed of execution is still subject to uncertainty. Privately funded construction of roads and facilities is often completed faster than similar publicly funded projects, because private investors have a direct financial incentive to complete a project faster, for example when expanding toll roads.

An often debated source of funding is petrol taxes. We do not expect this solution to be employed in the current situation, as it would probably become a hot political potato at the next election. On the other hand, some of the renovation projects may well be debt funded due to the current low level of interest rates. Funding will also quite likely be based on low-coupon treasury bonds with maturities of up to 100 years. Today, the longest maturities on US treasury bonds is 30 years, but in their search for yield, investors are willing to accept low returns, even at 100-year maturities.

Another proposal has been to raise funding through Trump's corporate tax reform, which would impose tariffs on non-US-made goods. The reform is also intended to promote US-made products, and companies that have previously moved production abroad are now repatriating and contributing to US economic growth.

> **Trump has received positive indications from Congress on his proposed infrastructure investments.**

Tailwinds for CRH and Siemens

Millions of people voted for Trump because of his promise to create jobs. His plan is to start extensive infrastructure renovation projects all over the US. Companies that will benefit from such public investment in the coming years include CRH and Siemens, which have exposure to building materials and energy grid expansion projects.

CRH aims to become the world's largest building materials company. Infrastructure accounts for about 30 pct. of its business. CRH specialises in acquiring small and medium sized businesses and integrating them into its existing business. For example, CRH acquired cement manufacturer LafargeHolcim when those two companies merged. While the EUR 6 billion deal was a relatively large transaction for CRH, it was also reasonably priced, and today it would look as though CRH acquired LafargeHolcim at a strategically opportune time.

CRH generates about 50 pct. of its revenue in the US and about 30 pct. in Europe. The group is also the largest manufacturer of asphalt and the third largest producer of both aggregates and ready-mixed concrete in the USA. It owns about 80 pct. of the aggregate reserves it produces. As it ships supplies to most parts of the USA and Europe, CRH is also experienced in the transport of building materials. Because CRH has extensive building materials operations in its infrastructure division, we believe that going forward the group will be looking for businesses providing distribution and logistics services and related products.

As CRH targets a net debt/EBITDA (2017e) ratio of about 2x, we believe the group will be able to make new acquisitions totalling about EUR 4.5 billion over the next few years, which would in turn, potentially lead to a further 15-20 pct. earnings improvement. However, achieving that target is subject to management continuing its disciplined acquisition strategy.

We estimate that CRH's relatively high P/E 2017 ratio of about 16x can be reduced to about 10x if we include earnings growth from acquisitions and cyclical normalisation of sector earnings. We consider this to be a reasonable pricing for exposure to infrastructure restoration in both the USA and Europe.

Siemens is one of the world's largest conglomerates in the capital goods industry. The group has extensive exposure to expansion and maintenance of the global energy grid. Siemens offers a wide range of products, spanning from gas turbines and wind turbines to software and service for power distribution and intelligent network infrastructure solutions (Smart Grids). Siemens' competitive position drives its sales growth (of 3-5 pct.). We also have quite high expectations to the group's internal restructuring projects. Management has been focused on cost cutting and portfolio optimisation. Current plans involve spinning off and floating its healthcare division.

Its annual R&D budget of EUR 5 billion makes Siemens strongly positioned for the future. The group is already a pioneer in terms of products and solutions for the "Digital Factory", which connects and allows machinery, equipment, sensors and people to communicate through the "Internet of Things" and the "Internet of People". Siemens shares are trading at an attractive P/E valuation of 14-15x (2017-18e), and the group generates a strong free cash flow, enabling an attractive and growing dividend of just over 3 pct.

Our Global Equities strategy has been invested in CRH and Siemens since November/December 2016.