Analyst Corner

By: Nathan Ritz, CFA · July 2019

A Look at Construction Aggregates and Cement

Construction aggregates (rocks and gravel) and cement are critical inputs into our nation's infrastructure, roadways, commercial and public buildings, and residential developments. We have over a decade of history in the construction materials space, as we invested in several companies coming out of the 2008 housing bust. With stock weakness during the second half of 2018, we were again able to build positions in several construction aggregates and cement companies: Vulcan Materials (VMC), Martin Marietta Materials (MLM), Eagle Materials (EXP) and Summit Materials (SUM). Each company has a durable and expanding competitive moat.

At a cost of just $12 per ton, construction aggregates have the lowest cost-to-weight ratio of any material on the planet. Due to the low ratio, most aggregates are shipped within a 25-mile radius from the quarry, as the transportation costs quickly become more expensive than the product cost itself when shipped greater distances. While cement markets aren't as "local" as aggregates markets, cement is still typically sold within a 150-mile radius. This cost-to-weight dynamic naturally creates local markets for aggregates and cement, with barriers to entry from outside competition. Moreover, as time passes, our companies' assets become more valuable. As our country's wealth has expanded and as our city centers have grown, it has become increasingly difficult to purchase, permit and build new aggregate quarries and cement plants. A combination of new environmental regulations, a more difficult permitting process, and public opposition ("not in my backyard") has limited the new capacity entering the market. Today there are no more aggregate quarries in operation than there were 30 years ago, and fewer cement plants than a decade ago, despite significant population growth and higher economic output. At the same time, we've seen industry consolidation as public and private companies rolled-up their regional markets. The combination of a favorably structured industry and market consolidation has led to strong and resilient pricing power that has meaningfully outpaced inflation over time. The above dynamics favor incumbent players with strong asset reserves, operating in consolidated markets near fast-growing metropolitan statistical areas (MSA). Our companies are among the best positioned in this regard.

In addition to business quality, we see attractive industry fundamentals and a long growth runway for the groups' largest end market, public construction. The underinvestment in our nation's infrastructure and roadways is well documented, as the U.S. has fallen behind many other developed nations. Public infrastructure is funded at both the federal and state/local level. Federal funding through the Fixing America's Surface Transportation (FAST) Act has only increased slightly but provides us visibility through 2020. Our interest in public construction has increased over the past few years, as it's clear that state and local authorities have realized demand is pressing, and they can no longer rely on the federal government to make the needed investments. States have taken measures into their own hands, with 31 states passing legislation to increase taxes on gasoline and diesel. States are also being creative with other dedicated funding sources such as vehicle registration taxes; truck, alternative vehicle and ride sharing taxes; hotel taxes; sales, casino and cigarette taxes; and taxes on oil and gas revenue. In many cases, the magnitude of state-level increases has eclipsed federal funding levels. For example, in Vulcan Materials' top 10 states, which represent 80% of revenue, public funding is up 60% compared to 2015. The increase in dedicated funding sources has given state departments of transportation (DOTs) the visibility needed to approve new large-scale capital projects. These projects are longer duration (4-8 years) and are aggregates intensive; our companies sell more aggregates with new road construction and lane expansion projects than maintenance projects. After a period of planning and zoning, these large-scale projects are just now beginning to reach the construction phase, which gives us multiyear visibility into strong public demand for our companies. Additionally, public construction is less sensitive to economic cycles and interest rate fluctuations than private construction, which should give our companies some level of resiliency over the next three to five years.

Vulcan Materials (VMC) is the largest pure play aggregates producer in the U.S. They are attractively located in faster growth "smile states" (south, east and west coasts). The company has made several positive acquisitions to consolidate their markets, with the most recent being Aggregates USA in the Southeast. Martin Marietta Materials (MLM) is the second-largest aggregates producer, a top 10 player in cement and a leading producer of magnesia specialties. MLM has a leading position in the attractive Texas market, has been a market leader in pricing and has one of the best capital allocation track records in the space. We've been proponents of Eagle Materials (EXP) due to their low-cost positions in cement and wallboard as well as their history of operational and commercial excellence. Shortly after we established a position in Eagle, an activist investor initiated a position and advocated for a break-up of their cement and wallboard businesses, sending the stock higher. In May, the board approved a plan to split into two publicly traded companies and sell their smaller frac sand business. Finally, Summit Materials (SUM) is a smaller player with aggregates, cement and downstream (ready-mix concrete and asphalt paving) businesses. Summit is led by industry veteran Tom Hill, who has made attractive acquisitions (many at depressed prices) to roll-up markets throughout the Midwest. In June, the stock rebounded as Argos, a Colombian cement manufacturer, entered talks to merge with Summit. While all four companies have posted strong returns over the past two quarters, we expect more upside ahead with projected annualized returns ranging from 13%-20% for our four holdings.

Nathan Ritz, CFA, *joined Weitz in 2011. He graduated from the University of Nebraska-Lincoln and became a CFA® charterholder in 2015. He previously completed an internship with Moody Aldrich Partners in Boston and worked as an analyst for West Gate Bank.*

As of June 30, 2019, each of the following portfolio companies constituted a portion of the net assets of Value Fund, Partners Value Fund, Partners III Opportunity Fund, Hickory Fund, and Balanced Fund as follows: Eagle Materials Inc.: 0%, 0%, 0%, 1.7%, and 1.2%. Martin Marietta Materials, Inc.: 0%, 2.1%, 0%, 0%, and 1.2%. Summit Materials, Inc.-Class A: 0%, 2.9%, 2.9%, 4.2%, and 0%. Vulcan Materials Co.: 2.9%, 2.2%, 0%, 1.6%, and 1.6%. Portfolio composition is subject to change at any time. Current and future portfolio holdings are subject to risk.

Investors should consider carefully the investment objectives, risks, and charges and expenses of the Funds before investing. The Funds' Prospectus contains this and other information about the Funds and should be read carefully before investing. The Prospectus is available from Weitz Investment Management, Inc. Weitz Securities, Inc. is the distributor of the Weitz Funds.