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JAGUAR THEMATIC TRADES

Arcosa (ACA): Getting More Selective on Infrastructure

We've probably sounded like a broken record pushing the "Buy America / Build America" infrastructure theme repeatedly throughout Q3 and Q4, together with our long recommendations in numerous beneficiaries within the space (AA, CR, FLR, J, ROAD, to name a few).

But now that these stocks have all run up, it begs the following questions:

- How much good news has already been priced in? AKA, are there any rumors left to buy?
- What if Biden allocates less spending than expected in one area (say, traditional construction) and instead prioritizes spending in other areas (such as cybersecurity/healthcare/5G/IT/education)?

Personally, I think there's still more upside to be had in infrastructure. But I also think it's safe to say that at this point, the euphoric "Midas touch" days of indiscreetly picking any stocks related to this theme, and expecting them all to go up in sympathy, are numbered. In other words**, it's time to start being more selective with what kind of infrastructure stocks we want to own, as Biden's first 100 days draw closer.**

Arcosa overview

A May 2019 spinoff from Trinity Industries, **Arcosa Inc. provides construction equipment, materials, and services to three major industries: energy (48% of revenue), transportation (27%), and traditional construction (25%).**

INDUSTRY SEGMENTS

CONSTRUCTION PRODUCTS

Strong geographic footprint and a product portfolio positioned to support infrastructure growth.

- Aggregates
- Specialty Materials
- Construction Site Support

ENERGY EQUIPMENT

Competitive manufacturing and sourcing advantages to grow in a dynamic energy landscape.

- Wind Towers
- Utility Structures
- Storage Tanks

TRANSPORTATION PRODUCTS

Market leadership in products critical to transportation infrastructure.

- Barges and Marine Hardware
- Rail Components
- Industrial Components

From a tactical perspective, the company is sort of like Jacobs Engineering (see Page 100 of 4Q20 Quarterly Outlook here) in the sense that its infrastructure end markets are highly diversified. **Because what we're trying to do with this long idea is to spread our eggs in several baskets, to account for a scenario where the incoming Biden administration disappoints in some areas while prioritizing others.**

First, taking a look at Arcosa's Energy Equipment segment

The company's Arcosa Wind Towers subsidiary is one of the largest manufacturers of wind energy towers for wind farms across North America. As one would expect, this part of the business has been a major beneficiary of production tax credit hikes and incentive extensions, which has helped the company report positive revenue growth for the entire segment throughout the year (+7% YoY in Q1, +9% in Q2, and +7% in Q3) despite the pandemic. **Looking ahead, that tailwind is set to continue after Congress passed on December 21st a $35B spending bill on clean energy R&D, which includes a 1-year extension of production tax credits for wind projects and an extension through 2025 for offshore wind tax credits, remaining at 30%.** Specifically, the provisions were included in the $1.4T extension package alongside the $900B coronavirus relief package.

The other major subsidiary within the Energy segment is Meyer Utility Structures, which is responsible for the construction and installation of electric transmission systems, mainly in the US and Mexico. Mainly pylons and substation work. While not as fast growing as the wind business, Meyer Utility tends to enjoy the steadiest and most predictable cash flows relative to the rest of Arcosa, due to them serving large utility customers via long-term alliance contracts that can extend for several years at a time. Nonetheless, it's worth noting that **CEO Antonio Carrillo mentioned during the Q3 earnings call utility structure demand is picking up sharply:**

> *"**The utility structure market is extremely strong with demand outpacing our current production capacity.** Utility customers continue to implement grid hardening and reliability initiatives, as well as invest in renewable connections."*

Also note that following a series of acquisitions in 1H20 totalling ~$340M, the company has recently expanded into telecommunication, traffic, lighting, and concrete transmission structures, which are expected to benefit from the 5G build-up and anticipated transportation infrastructure packages. According to Carrillo:

> *"Our new acquisitions of traffic and telecom structures and concrete poles are doing well with **strong backlogs and positive trends**. We're in the beginning stages of this integration and **have started to achieve early commercial and operational synergies**… We're very excited about the possibilities and the ramp up we expect to see over the next several quarters."*

Lastly, there is Arcosa Tank, which makes steel pressure energy storage tanks (ammonia and propane gas) for residential, commercial, and industrial use. While this business should see some benefit from "Buy America / Build America", it's not exactly a major contributor to total revenue (representing only ~10% of Energy segment sales). That said, management did point to stabilizing demand in recent months following a difficult Q1 and Q2, while adding *"we have recently won several new orders for large infrastructure projects in Mexico."*

All in, the entire Energy segment has seen a backlog increase to $429.3M in Q3 vs quarter-ago $352.2M, with 2021-delivery wind tower orders of $154M and extending lead times for utility structures.

Transportation Products Segment

This segment houses two subsidiaries: Arcosa Marine and Arcosa Transportation Components.

Arcosa Marine **makes hopper, tank, and deck barges, as well as a wide range of specialized hardware that aids in the aquatic transportation of containers.** These barges are typically used to move dry products, liquids, and other bulk cargo along inland waterways.

Admittedly, this business has been slow to recover from the pandemic, with only $18M of received orders during Q3 (flat vs Q2) and backlogs further declining to $178M (vs $259M in Q2). Under the hood, management states that the dry barge market is currently seeing *"significantly improved fundamentals driven by grain movements and higher freight rates"*, but *"the liquid barge market remains weak as refined products, petrochemicals, and crude oil movements have not yet recovered from the pandemic."*

In other words, the picture is likely to remain mixed until the shale industry returns to a capex growth environment (a topic we have gone into detail for one of the Premium Ideas in our latest Q1 2021 Quarterly Outlook, which can be purchased here). Despite the downbeat situation, CEO Carrillo alluded to some improvement since the start of Q4:

> *"Even though we only received $18M in new orders during the quarter [Q3], **in the last few weeks, we have seen significant improvement in inquiries and have closed $32M of additional barge orders for 2021**."*

That figure is still nowhere near the $84M reported in 4Q19. But at least it's something to build on going into next year.

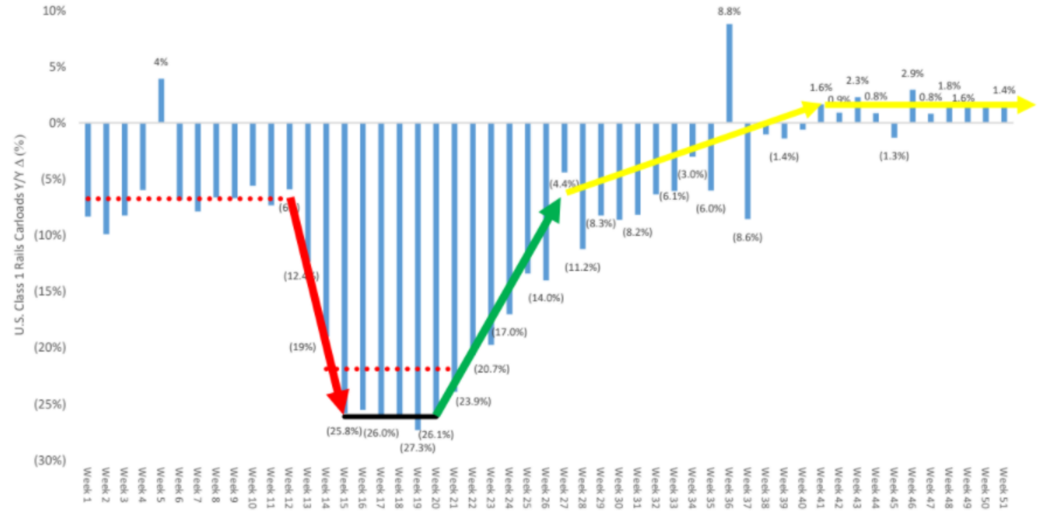
Meanwhile, Arcosa Transportation Components **makes all sorts of modules for rail, trucking, and shipping transporters, as well as mining equipment parts.** The biggest sellers for this business are railcar coupling devices, railcar axles, and circular forgings. Naturally, this implies the railway industry is their biggest customer here, though the company has been trying to diversify into non-rail markets in the midst of the pandemic, with some success.

Unlike the barge business, Arcosa management is noticeably more bullish on this sub-segment:

> *"**we are hopeful that we have reached a low point in the [rail cargo] cycle.** We've been EBITDA positive throughout the downturn and have had **additional success in winning new orders for the more stable, maintenance and non-rail markets**… If the rail industry recovers, I think we have a very nice uptick in our business, because we've been able to cut our costs so much."*

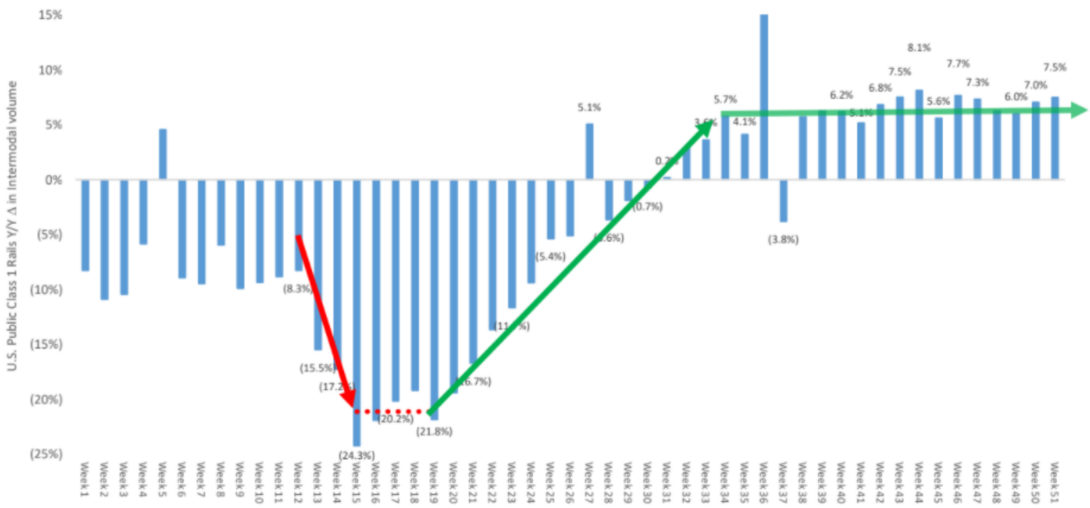
This optimistic commentary is consistent with the latest channel checks from Stifel on December 29th, which show that YoY rail volume comparisons (on a weekly basis) for the current quarter are better than they were in Q1, prior to COVID-19.

Exhibit 1: Rails posting positive y/y comps in 4Q20, which hadn't been the case prior to the pandemic and concomitant lockdowns.



Source: AAR (Association of American Railroads)

Exhibit 8: Intermodal Volume continues to lead the overall volume improvement



Source: AAR

Construction Products Segment

This segment is made up of three divisions, which together provide basic and manufactured materials for a wide range of traditional construction projects (includes residential, commercial, and industrial infrastructure).

Essentially, the company:

- **Operates natural sand, gravel, and limestone reserves in over 11 locations** (they're the top sand and gravel producer in Texas), and oversees mining and processing.

- **Is also the largest producer of rotary kiln expanded shale and clay lightweight aggregate in North America.** These are mostly used for road/bridge construction and the production of structural lightweight concrete, but the aggregate also has all sorts of applications in commercial/industrial buildings, water filtration and treatment, precast concrete, etc.

- **Manufactures steel and aluminum "trench shoring and shielding" equipment** (as shown by the right-most image above), which are used to protect workers and construction sites from cave ins that can occur below the ground level.

Note that this Construction Products segment is where Arcosa has done the most acquisitions recently (totaling ~$735M), as it appears management is betting big on "Buy America / Build America":

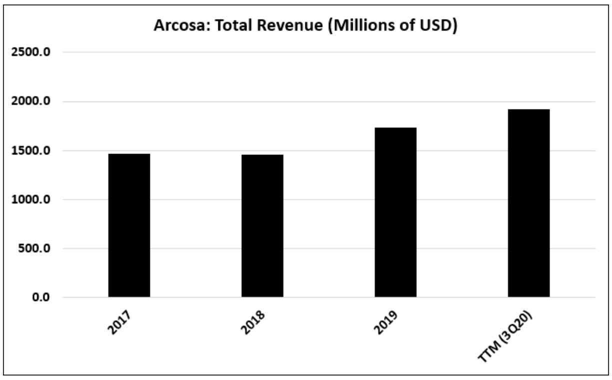
Just like the Energy Equipment segment, sales from this segment have been robust throughout 2020, increasing 41% YoY to $149M in Q1, up 28% to $148M in Q2, and up 27% to $147M in Q3. Additionally, the acquisitions of Strata Materials and Cherry have opened up a new avenue for Arcosa in recycled and natural aggregates.

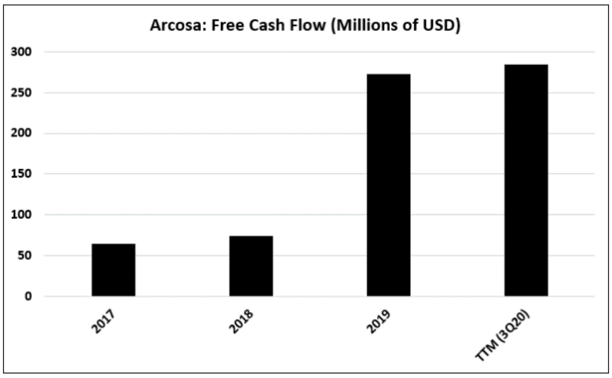
We've already spent the last several months pointing out plenty of evidence (from Caterpillar and Deere orders, to truck demand, to railcar volumes, to copper prices, etc.) that a new infrastructure upcycle is well underway. **So, it shouldn't come as a surprise that Arcosa management commentary points to a very promising 2021 for construction:**

> *"**The majority of the aggregates business is located in high-growth geographies, particularly Texas**, where construction activity has remained robust. In the short term, lower state budgets could dampen infrastructure spending, **but our federal stimulus plan including infrastructure investment could offer upside. We were pleased to see the one-year extension of the FAST Act**…*
>
> *We will have Strata for the full year; we will have all these small acquisitions that we did for the full year. And, we have organic growth. We've invested in the Houston area, Scott mentioned. We're investing around the Dallas-Fort Worth area, we're investing around some of their operations. And the shoring business is looking better… **I think, the construction segment, if you put all of those together, we're very positive about growing it in 2021 at a very healthy level**."*

Arcosa intends to take advantage of its strong cash flows

Apart from being a potentially beneficiary of fiscal infrastructure spending, **the other major bull case for Arcosa is that the company's cash generation has improved markedly as a result of its 2019 spinoff from Trinity, alongside revenue**:





Looking at management commentary, the biggest driver of this appears to be working capital reductions. The leadership is prioritizing a "cash culture" at the company, and according to them, there is still further room for expense reductions:

- **CEO Carrillo:** *"**We're building a strong cash culture at Arcosa.** The impressive $93 million of free cash flow in the third quarter brings our year-to-date total to $170 million, as **we focus on reducing our working capital and operating more efficiently. This cash culture is helping us deploy growth capital into attractive markets while maintaining low leverage. We still have opportunities to improve**, especially in the inventory and accounts payable management, but I'm excited with the progress made to-date."*

- **CFO Scott Beasley:** *"I think, **the biggest thing we've done is create a focus on cash culture, where everybody is very-focused on cash, when we spun off from our former parent company**, that hadn't been a priority. And so, over the last two years, we've been trying to build the cultural foundation. We've seen a lot of success and we generated about $170 million of free cash flow this* *year, thus far, $93 million in the quarter. I'd say **we've made the most progress in our accounts receivable. We have made progress in accounts payable, have room to go. And then, inventory remains probably the biggest opportunity**, where it's a little harder to get, because it involves more full kind of operational redesigns but we think that we have opportunities in inventory too. So, across inventory and AP, I think, we still have room to improve working capital and we're optimistic that we can do that next year."*

Bottom line: With only $250M of debt on their balance sheet (and 0.13 Debt/Equity), this improved cash flow generation ability will allow management to continue making acquisitions for their Construction and Energy segments while keeping leverage low. So, this is not just an organic growth story, as there is also growth from M&A without the need to borrow.

Midwest Industrial Summit commentary

On December 14th, Arcosa provided the following qualitative updates at the Midwest Industrial Summit:

- Construction activity remains strong, and the company continues to have minimal exposure to high-risk states, chiefly California. **This segment could see an additional tailwind from the recent extension of the FAST Act and more targeted state level spending bills, like Texas's 10-year $75B construction budget.** Interestingly, Oppenheimer analyst Ian Zaffino noted that management said *"a federal infrastructure bill is a nice-to-have, not need-to-have."*

- The Energy segment is expected to benefit from *"grid hardening"* efforts, 5G buildouts, and overall infrastructure spending. **Tailwinds include an infrastructure/renewable bill, successful antidumping cases against India, Malaysia, and Spain, and also the private sector's push toward renewables.**

- Within the Transportation segment, dry and bulk shipment levels remain favourable for barges, driven by strength in agriculture and demand from China. **Additionally, only ~175 barges have been produced annually over the past four years vs replacement levels of ~500 units.** On the flip side, demand remains weak for the shipping of crude, refined products, and petrochemicals.

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