COMMENTARY

June 1, 2018

Dear clients and colleagues,

We recently attended the 2018 B. Riley Small Cap Investor Conference in Santa Monica, California. The event is becoming a key venue for small caps as a result of B. Riley's multi-merger with Friedman Billings Ramsey and Wunderlich Securities. This growing conference allowed us to meet companies from a variety of sectors of the economy.

Semiconductor companies continue to have a positive outlook as they prepare for the transition to 5G technology. Software as a Service companies also remain upbeat as the conversion to subscription models continues. Companies in conventional industries, such as oil & gas and construction, are also upbeat and now speak of growth, not recovery. This is in line with macroeconomic comments that were frequently made in Q1/2018.

Looking at the Baker Hughes industry survey of oil exploration drill rigs, the number of drill rigs has continued to increase, with the addition of 10 or more rigs per week since the beginning of April. This brings the industry total rig count to 908 as at May 25; however, this is still below the last cycle peak of 2,000 rigs. Strong rig acceleration often proves to be an indicator of a robust oil price environment. Rig count acceleration also brings inflationary pricing and volume to service and ancillary activities such as materials supply and construction.

As if construction needed a boost! In 2017, public and private sector construction reached $1.2 trillion, surpassing the $1.15 trillion peak reached in 2006. Producer Price Index (PPI) material input costs for all construction (excluding labour) were up 4.2% in 2017. Infrastructure input costs were up 5%, and single-family residential home input costs were up 4.3%. Material inputs account for only a portion of the total cost to construct a building. Labour input costs are currently increasing. Unemployment in the construction industry is at its lowest level on record. According to one homebuilder at the conference, the amount of time it takes to build a single-family home has increase from four to seven months, another worrisome indicator of low availability and quality of labour.

When asked about a potential construction slowdown due to price inflation, one conference attendee, an infrastructure company executive, noted that his firm's municipal and state clients were aggressively executing work and are having no issues carrying the inflation risk. The first sign of a downturn would be work cancellation. However, the necessity to perform infrastructure upgrades is omnipresent:

- Bridges: The most recent data show that 9.1% of bridges in America are structurally deficient and 14% are functionally obsolete. It would cost $123 billion to eliminate the bridge repair backlog.

- Roads: Poor roads cost Americans $160 billion in lost time and wasted gas per year. Two out of five urban interstate miles are congested, while one in five miles of pavement across the country is in poor condition.

- Water: About 240,000 water mains break in the US each year, leading to the waste of 2 trillion gallons of drinking water annually. At the current rate, it would take 200 years to replace all the pipes in need of repair across the country, a timeline that would put most well beyond their useful life.

- Energy: The US power grid is at full capacity, and as demand grows, power outages will become more likely. More than $177 billion is needed to upgrade the grid between now and 2025. Data from the latest year available estimated that 3,571 electricity outages were due to aging infrastructure.

With easy access to capital, municipalities and states continue to move forward with infrastructure improvement projects. Furthermore, these agencies are not relying on a potential infrastructure package from the federal government to forge ahead. So it is not surprising that the Trump administration is continuously lowering the priority of its infrastructure bill.

In addition to direct participants, Global Alpha is exposed to suppliers of the construction industry and the oil & gas service industry. These industries tend to commingle in North America, especially through the cement, aggregates, water and sand supply segments.

US Silica (SLCA, $30.93)

SLCA is a 115-year-old vertically integrated player in the US frac sand market. It owns three decades' worth of sand reserves and controls an additional approximately 430M tons of proven and probable sand reserves. Growth in proppants for drilling has expanded dramatically due to technological advancements.

Summit Materials (SUM, $28.04)

SUM is an integrated heavy construction materials firm. The company has its own aggregates reserves (the eighth largest in the US at 2.1B tons) and cement reserves (a top 15 player). These are the materials used in products such as asphalt. Summit produces asphalt (the ninth largest producer in the US at 4.5M tons annually) and ready-mixed concrete for sale and for use in its paving operations.

Salini Impregilo (SAL, €2.12 EUR)

SAL is an Italian-based, large heavy civil infrastructure contractor operating in markets around the world. The company's main business segments are: tunneling, highways and bridges, rail and mass transit, paving, water and airports. Active in 50 countries, the geographic mix is US 23%, Middle East 24%, Europe 16%, Africa 18%, Italy 9%, Asia/Australia 6% and Americas 4%.

Have a great weekend.

The Global Alpha team