Knife River Corp

Sharpening the Knife: Initiate at Buy

Initiating Coverage: BUY | PO: 81.00 USD | Price: 62.45 USD

05 January 2024

Equity

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Turnaround bearing fruit ahead of schedule

We initiate coverage of Knife River with a Buy rating and $81 PO, implying 29% upside. KNF is a leading (top 10) national producer of aggregates, ready-mix concrete, asphalt, and contracting services. It operates across Pacific, Northwest, and Mountain regions with little overlap from larger public peers. Its end markets also skew heavily towards public works projects, and we expect KNF to benefit from healthy state budgets and infrastructure spending. Spun off from MDU Resources in June, KNF has executed very well on Ops improvements since then. We expect its turnaround efforts to continue to show through in cost controls, and (importantly) EBITDA margin (+270bps YoY 2023 EBITDA guide) as it scales up its materials business & grows into its (largely public works) contracting exposure. We think KNF has a clear path forward as a consolidator and value compounder utilizing its EDGE initiative (see exhibit 3).

Construction material markets are favorable

KNF has delivered record gross profit per ton in its first months as a standalone company, with pricing across some products broadly in line or above that of large public peers despite shipments being ~20% below peak. We think this is a function of compounding price growth as standardized best practices are put in place, high barriers to entry, lack of substitution, & operational efficiency initiatives. This positions KNF well to benefit from a materials/construction upcycle.

Strong M&A record, ample FCF to drive consolidation

KNF is the leading materials producer in most of its territories, however that translates to just 30-40% share. This gives it a wide runaway for M&A. (the firm has a long history of M&A, itself formed from 80+ smaller regional companies.) unconsolidated markets and stable FCF align well to M&A. Knife River expects to further consolidate and build scale. Historically transactions have averaged ~$30mn or less ($153mn op cash YTD).

KNF trades at a discount despite recent share price gains

While KNF's shares are up 70% since the spin-off, it continues to trade at a discount to peers/recent transaction in the space. Our PO is based on 11.0x 2024E EV/EBITDA. By contrast, pure play aggregates such as VMC and MLM trade at 14-16x. ROAD (asphalt/ paving/contracting work) trades at 11-12x as its pricing power is more limited vs upstream aggregates. CRH Plc recently purchased $2.1bn of cement and ready-mix concrete assets in Texas from MLM at 12.4x EBITDA.

Estimates (Dec) (US$)	2021	2022A	2023E	2024E	2025E
EPS	NA	2.05	2.98	3.36	3.76
EPS Change (YoY)	NA	NA	45.4%	12.8%	11.9%
Consensus EPS (Bloomberg)			3.08	3.29	3.80
DPS	NA	0	0	0	0
Valuation (Dec)					
P/E	NA	30.5x	21.0x	18.6x	16.6x
EV / EBITDA*	NA	13.9x	10.4x	9.7x	8.8x
Free Cash Flow Yield*	NA	1.5%	4.2%	4.6%	5.0%

* For full definitions of *iQmethod* SM measures, see page 15.

Stock Data

Price	62.45 USD
Price Objective	81.00 USD
Date Established	5-Jan-2024
Investment Opinion	C-1-9
52-Week Range	33.67 USD - 67.43 USD
Mrkt Val (mn) / Shares Out (mn)	3,533 USD / 56.6
Free Float	99.2%
Average Daily Value (mn)	31.40 USD
BofA Ticker / Exchange	KNF / NYS
Bloomberg / Reuters	KNF US / KNF.N
ROE (2023E)	15.1%
Net Dbt to Eqty (Dec-2022A)	65.6%

VMC: Vulcan Materials

MLM: Martin Marietta Materials

ROAD: Construction Partners Inc.

Timestamp: 05 January 2024 06:00AM EST

iQprofile SM Knife River Corp

iQ**method* SM **– Bus Performance

(US$ Millions)	2021	2022A	2023E	2024E	2025E
Return on Capital Employed	NA	NA	9.6%	9.8%	9.8%
Return on Equity	NA	22.6%	15.1%	14.7%	14.2%
Operating Margin	NA	7.7%	10.1%	10.8%	11.3%
Free Cash Flow	NA	52	150	164	178

iQ**method* SM **– Quality of Earnings

(US$ Millions)	2021	2022A	2023E	2024E	2025E
Cash Realization Ratio	NA	1.8x	1.6x	1.6x	1.6x
Asset Replacement Ratio	NA	1.3x	1.0x	1.1x	1.2x
Tax Rate	NA	26.8%	26.0%	26.0%	26.0%
Net Debt-to-Equity Ratio	NA	65.6%	43.8%	26.0%	11.4%
Interest Cover	NA	6.5x	5.1x	5.4x	6.1x

Income Statement Data (Dec)

(US$ Millions)	2021	2022A	2023E	2024E	2025E
Sales	NA	2,535	2,750	2,930	3,050
% Change	NA	NA	8.5%	6.5%	4.1%
Gross Profit	NA	361	496	541	570
% Change	NA	NA	37.3%	9.1%	5.4%
EBITDA	NA	313	420	450	495
% Change	NA	NA	34.0%	7.2%	10.0%
Net Interest & Other Income	NA	(35)	(51)	(58)	(56)
Net Income (Adjusted)	**NA**	**116**	**169**	**190**	**213**
% Change	**NA**	**NA**	**45.0%**	**12.9%**	**12.1%**

Free Cash Flow Data (Dec)

(US$ Millions)	2021	2022A	2023E	2024E	2025E
Net Income from Cont Operations (GAAP)	NA	116	169	190	213
Depreciation & Amortization	NA	118	120	130	140
Change in Working Capital	NA	(21)	(15)	(17)	(8)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	NA	(5)	2	2	3
Capital Expenditure	NA	(155)	(125)	(141)	(170)
Free Cash Flow	**NA**	**52**	**150**	**164**	**178**
% Change	**NA**	**NA**	**187.2%**	**9.6%**	**8.2%**
Share / Issue Repurchase	NA	NA	NA	NA	NA
Cost of Dividends Paid	NA	NA	NA	NA	NA
Change in Debt	NA	1	100	0	0

Balance Sheet Data (Dec)

(US$ Millions)	2021	2022A	2023E	2024E	2025E
Cash & Equivalents	NA	10	260	424	602
Trade Receivables	NA	210	226	237	247
Other Current Assets	NA	388	393	408	411
Property, Plant & Equipment	NA	1,315	1,320	1,331	1,361
Other Non-Current Assets	NA	371	371	371	371
Total Assets	**NA**	**2,294**	**2,570**	**2,771**	**2,991**
Short-Term Debt	NA	238	238	238	238
Other Current Liabilities	NA	279	284	293	297
Long-Term Debt	NA	447	547	547	547
Other Non-Current Liabilities	NA	302	302	302	302
Total Liabilities	**NA**	**1,266**	**1,371**	**1,380**	**1,384**
Total Equity	**NA**	**1,029**	**1,199**	**1,391**	**1,607**
Total Equity & Liabilities	**NA**	**2,294**	**2,570**	**2,771**	**2,991**

* For full definitions of *iQmethod* SM measures, see page 15.

Company Sector

Building Materials

Company Description

Knife River is a leading provider of aggregate based construction materials and contracting services. The firm is vertically integrated, with aggregates used in downstream products such as ready-mix concrete and asphalt. Knife River operates primarily in the Pacific, North West and Mountain regions, targeting high-growth mid size markets.

Investment Rationale

We rate Knife River shares at a Buy. With the split from MDU, there is room for greater focus on operational improvements, driving margin and earnings. The operational improvements come at a time when non-residential construction is underpinned by stimulus and other factors driving a sustained period of growth. We believe investors are likely to appreciate KNF's ability to drive operational improvement, favorable territories and favorable relative valuation vs other public aggregate names.

Stock Data

Average Daily Volume	497,669

Quarterly Earnings Estimates

	2022	2023
Q1	-0.71A	-0.73A
Q2	0.68A	1.00A
Q3	1.76A	2.58A
Q4	0.32A	0.11E

Sharpening the knife

We initiate coverage of Knife River (KNF) with a Buy rating and $81 PO. KNF is a leading (top 10) producer of aggregates, ready-mix concrete, asphalt, and a contracting services provider. Aggregates (i.e., crushed stone, sand, gravel) are used across all types of construction, and much of Knife River's aggregate production is used internally. We see structural and cyclical factors underpinning a sustained period of growth and margin expansion. Knife River spun off from MDU Resources on June 1, 2023 and the renewed focus has already driven operational improvements, as KNF addresses its less favorable historical operating methods, and standardizes best practices across regions. Addressing low hanging fruit, should help KNF to capitalize on the structural drivers of aggregate demand in the coming years (infrastructure funding etc.), with valuation set to improve alongside margin, mix, and FCF generation.

Investment positives

Making progress quickly; Delivering early against margin targets

KNF is delivering against targets outlined at its May 2023 Investor Day. Updated guidance for 2023 has EBITDA margin (15.1% vs 12.4% 2022) just above 2025 projects at the Investor Day (15%). KNF is well on the way to a long-term target of 20%.

End markets remain resilient; Infrastructure should provide a nice tailwind

KNF's end markets skew heavily toward public works projects, backed by infrastructure stimulus and state budgets. We expect momentum across markets to drive low single digit annual shipment growth in the out years given healthy state budgets, Infrastructure funding, and growth in mega-projects. Expected rate cuts by the Fed this year could help drive demand.

Plenty of runway for consolidation in territories

While KNF is the leader across the majority (~70%) of the markets it operates in, there is room for consolidation as that position translates to ~30-40% share. Transactions have averaged $30mn or less, leaving room for several a year funded from FCF.

Discount to peers

Knife River is trading at a discount to peers. The firm trades at a 5x discount to aggregate heavy names MLM and VMC, and a 2x discount to asphalt and paving firm ROAD and recent cement/ready-mix concrete transactions in the space.

Investment concerns

Portfolio mix

Knife River is an aggregate based business, but most of revenue comes from lower margin downstream products (concrete, contracting, asphalt). Given that, the company is working to increase 'high quality' (pricing, barriers to entry) aggregate exposure (page 5).

Geographic Mix

KNF's operating states tend to grow faster than the US average. That said, many are prone to more severe winter weather (vs ROAD with SE exposure) introducing more seasonality. Some states (e.g. CA, IA, HI) are growing slower than the national avg. Additionally, recent gains in ready-mix and asphalt pricing have brought KNF largely in line with peers, potentially limiting upside from pricing in these materials going forward.

Growth risks: higher rates cool housing and knock-on impact to non-residential

With the significant rise in interest rates, segments of residential (e.g. multi-family) are expected to slow. While non-residential remains resilient, the potential for rates to weigh on growth remains, which could result in a lower growth outlook for Knife River

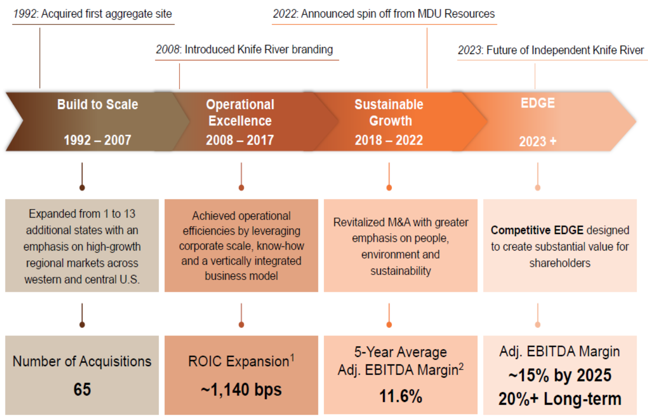
Limited history as an independent entity

Knife River has little track record as an independent firm. While the company has made progress in driving pricing/margins, operational improvements/execution risks remain.

A brief History of Knife River

Knife River began as a coal mining firm, with its first aggregate purchase coming in 1992 as part of MDU Resources group (acquired in 1985 as part of Montana-Dakota Utilities). The firm stopped supplying coal in the 90's, pivoting to create an aggregate based company. Over the course of 15 years, 65 firms were acquired to become the base of Knife River today. The firm operates in the North central, Mountain and Pacific Northwest of the US, with a focus on mid-size, high-growth markets. Knife River focused on driving return on capital with the reformatted business, driving ROIC up 1,140bps from 2008-2017. Post 2017, KNF pivoted back to being more acquisitive (80 acquisitions in total) to build scale in its core markets and drive sustainable growth.

Exhibit 1: Knife River's historical growth phases
Knife River has refocused their operating model



Source: Knife River Investor Day

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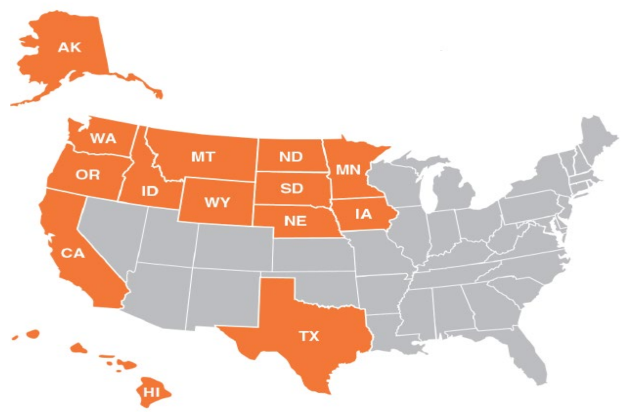
Exhibit 2: Knife River's Operating geography
Knife River operates in mid-size high-growth markets



Source: Knife River Investor Day

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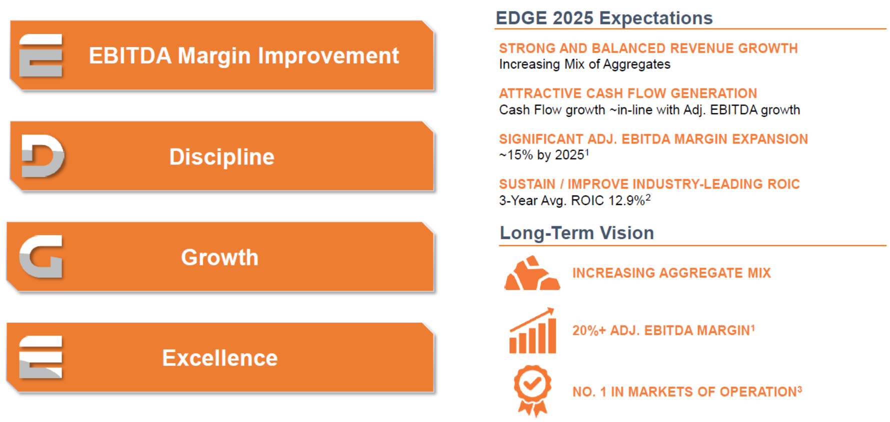
Post spin evolution: ability to refocus on performance

As a subsidiary of other firms, the typical priority for Knife River was to feed cash into the parent company given its strong FCF profile. With the spin-off, Knife River is now able to utilize its FCF to re-invest more heavily in operational improvements, drive aggregate revenue (and reserves) continue disciplined M&A, and implement best practices and standards across the footprint.

Exhibit 3: EDGE framework for value creation
Knife River has already met some 2025 targets this year



Source: Knife River Investor Day

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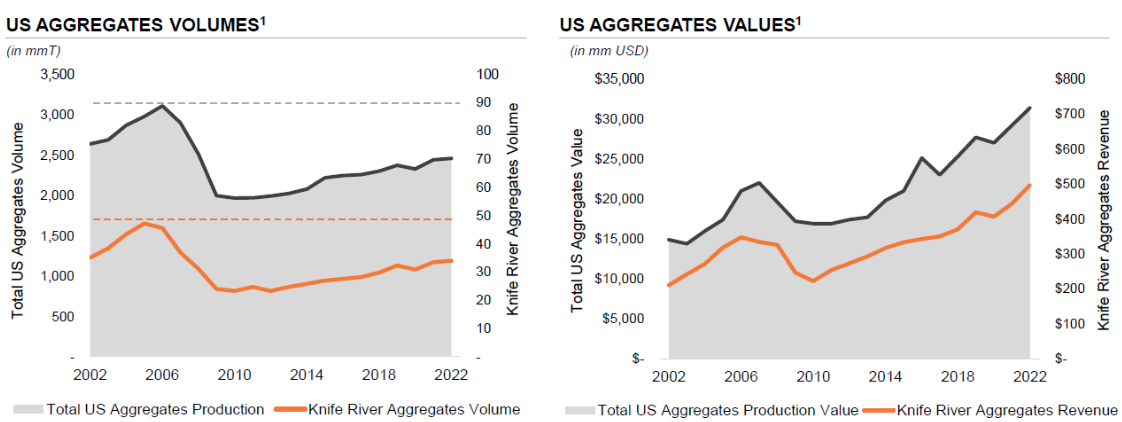
Aggregates: high quality asset

In our view, industry dynamics for aggregates (19% of 2022 gross profit) are highly favorable with high barriers to entry (zoning, regulations, environmental opposition, 'not in my backyard' complaints, 10-year permitting process), pricing power, and fragmented (~5k firms) markets. A growing mix of materials (focused on aggregates) underlies our positive long-term outlook for Knife River. KNF is the leading supplier of aggregates in ~70% of the markets it serves. Aggregates (primarily crushed stone, sand, and gravel) are used in virtually all types of public and private construction. There is no economical replacement for these aggregates, making for a stable, predictable business.

The US aggregate market totaled $31bn in 2022 (exhibit 4). Overall aggregate volumes in the US peaked at ~3bn tons before the global financial crisis and current volumes remain about 20% below peak despite a recovery the past decade. Volumes for Knife River have largely mirrored the national average, with capacity remaining across the industry. Coming out of the most recent recession (2009/10), it was a very slow recovery with fits and starts between residential vs non-residential vs public construction. For example, the aggregates shipment CAGR is just 2% over the last decade as the industry was hit hard from the housing-led recession. We believe volume growth can be higher this recovery. When one looks back at prior cycles (ex 2009/10), shipment growth was in the 5-6% CAGR range from the 1990s-2006.

Exhibit 4: Aggregate market volumes and values
Volume still well below peak



Source: Knife River Investor Day

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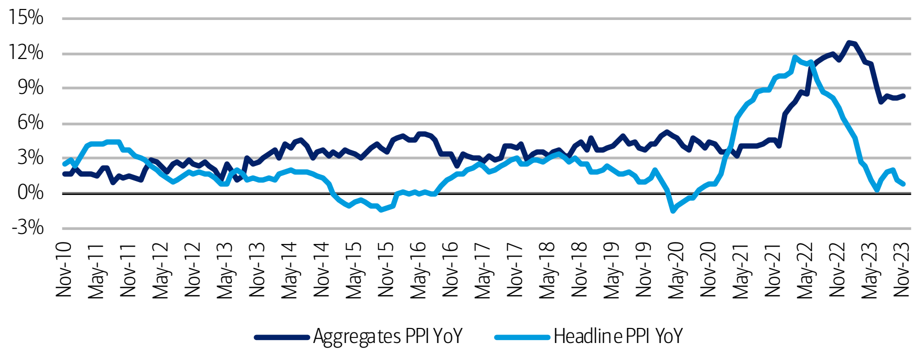
Volumes remain below prior peak, however revenues have grown. KNF's Revenue is 43% above prior peak despite lower volumes (pricing discipline), raising profits through cycle. These characteristics underscore the high-quality nature of the aggregate industry. While demand of aggregates can be volatile and cyclical (i.e., residential construction, public infrastructure, weather/project), aggregate pricing typically rises each year, even in recessionary environments. Profit-per-ton continues to rise to new highs despite below peak shipment per ton suggesting the industry is well positioned for an upcycle.

Pricing power outpaces CPI/Inflation

Aggregates pricing typically outpaces CPI on a YoY basis going back the last few decades (exhibit 5). Early in the pandemic pricing lagged CPI trends somewhat, but the trend has reverted in recent months. Aggregate pricing is likely to accelerate to help close the gap. KNF expects continued price growth. The cyclical demand backdrop for aggregate shipments is likely to improve over the next few years, setting up a better environment to push higher-than-normal price increases.

Exhibit 5: PPI Data YoY (sand, gravel) vs CPI YoY
Aggregate pricing generally outperforms CPI



Source: Bloomberg

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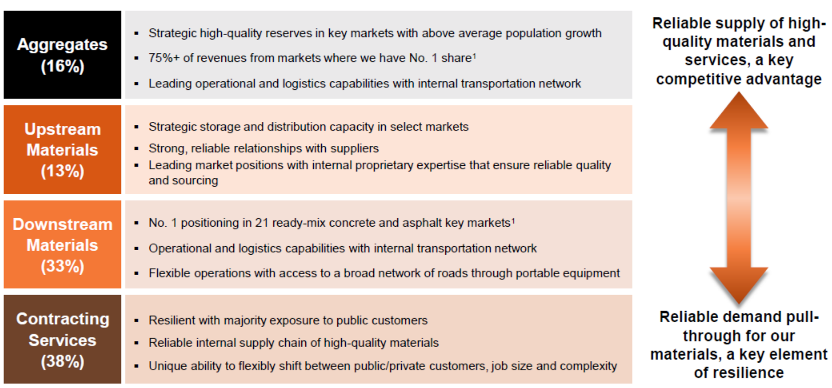
Downstream products and vertical integration

While Knife River is focused on growing aggregate exposure, the firm has notable exposure to downstream products which use aggregates as a primary ingredient, providing an 'internal customer' for produced aggregates and providing stability. Contracting services in turn provide a steady customer for downstream products. In total ~40% of aggregates produced are used in Knife River's downstream products, which also supply the firm's contracting services. While peers have shifted focus somewhat to more 'pureplay' aggregates, Knife River remains committed to vertical integration, with the firm co-mingling aggregate, asphalt, and concrete facilities where possible. By combining facility locations, all three product operations can be serviced by overlapping staff and equipment populations.

Exhibit 6: Value creation through vertical integration
Vertical integration provides reliable pull-through



Source: Knife River Investor Day

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Concrete and asphalt

Ready-mix concrete (~24% of 2022 gross profit) and asphalt (~12% of 2022 gross profit) make up a notable portion of Knife River's earnings. On the ready-mix side, Knife River sources cement offshore and acts as a distributor in a small number of cases in the Pacific region. By weight 80% of ready-mix concrete and 95% of asphalt are comprised of aggregates. Overall, we believe the downstream assets are 'lower quality' relative to upstream aggregates (i.e., aggregates are a key input to asphalt, ready-mix). However, we recognize the value of vertical integration benefits provided by these segments (multiple bites at the apple). additionally Knife River has seen notable pricing growth across ready-mix concrete and asphalt. In ready-mix the firm has seen averages prices that are higher than that of its larger public peers. In Asphalt, Knife River remains largely on par with larger public peers.

Exhibit 7: Ready-mix and Asphalt pricing
Knife River's pricing has kept up with that of larger peers

Ready-mix	2020	2021	2022	9M23
KNF	$ 133.86	$ 136.94	$ 151.80	$ 169.02
MLM	$ 113.57	$ 115.14	$ 128.15	$ 152.79
VMC	$ 128.93	$ 135.79	$ 150.82	$ 165.27
SUM	$ 116.47	$ 120.47	$ 136.47	$ 150.66
KNF		2.3%	10.9%	13.0%
MLM		1.4%	11.3%	21.9%
VMC		5.3%	11.1%	11.0%
SUM		3.4%	13.3%	12.5%

Asphalt	2020	2021	2022	9M23
KNF	$ 48.58	$ 47.86	$ 58.93	$ 66.41
MLM	$ 48.00	$ 49.96	$ 61.70	$ 65.71
VMC	$ 57.97	$ 58.83	$ 71.29	$ 75.37
SUM	$ 59.76	$ 61.05	$ 72.65	$ 84.36
KNF		-1.5%	23.1%	14.8%
MLM		4.1%	23.5%	7.4%
VMC		1.5%	21.2%	7.4%
SUM		2.2%	19.0%	17.6%

Source: Company Filings

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Contracting services: A public spending centric downstream materials market

Knife River acts as a general contractor and subcontractor for mostly 'horizontal' construction (streets, highways, airports, bridges). Services generally include aggregate laydown, asphalt paving, site development, concrete construction, and the manufacturing of pre-stressed concrete products. In 2022, 77% of the firms contracting service revenue was driven by public spending, with Knife River typically seeing between 60% and 90% of contracting work from public sources since 2007. The largest customers tend to be DOTs, with the top 15 customers comprising 20% of revenue. While KNF takes on a wide range of projects, the majority is paving (highways/runways) with 70% of produced asphalt sold to contracting services; a capital light business.

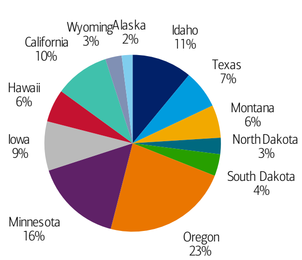
Other: Energy Services is small but a good contributor to performance

The other segment consists of Knife River's Energy Services business, South Region (Texas) and Corporate Services. The Energy Services business was purchased in 2005 and supplies liquid asphalt (the binding agent used alongside aggregates to produce asphalt mix). Knife River owns 5 (liquid asphalt) terminals where the firm stores and manufactures products. Knife River expects the Energy Services business to continue to contributor to 2024 EBITDA (carry forward contracts into 2024 shipping season), remaining above average, but below the levels seen in 2023. Strength in the business has been driven by favorable market pricing, and an exceptional bidding season.

Knife River's positioning

Knife River operates across 14 states (exhibit 8), in the Pacific, Northwest, Mountain and North Central regions. the firm targets mid-sized, high-growth markets (exhibits 9-10), and has little overlap with larger public peers in the construction materials space. Mid-sized markets tend to be less volatile than large metropolitan locations, which has helped KNF weather downturns. As shown in exhibit 11, peak to trough declines for revenue and EBITDA margin from 2007-2012 for KNF were more resilient than peers.

Exhibit 8: Gross revenue by state
Oregon and Minnesota are KNF's largest markets



Source: Knife River Investor Day

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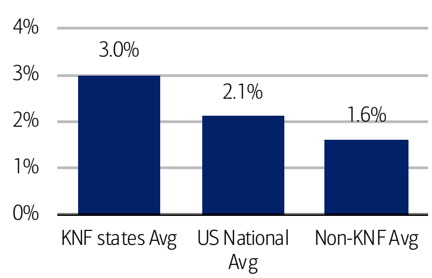
Exhibit 9: 10Yr gross state product CAGR
2010-2021



Source: Knife River Investor Day

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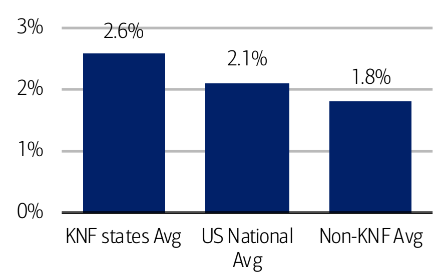
Exhibit 10: 10Yr construction industry CAGR
2010-2021



Source: Knife River Investor Day

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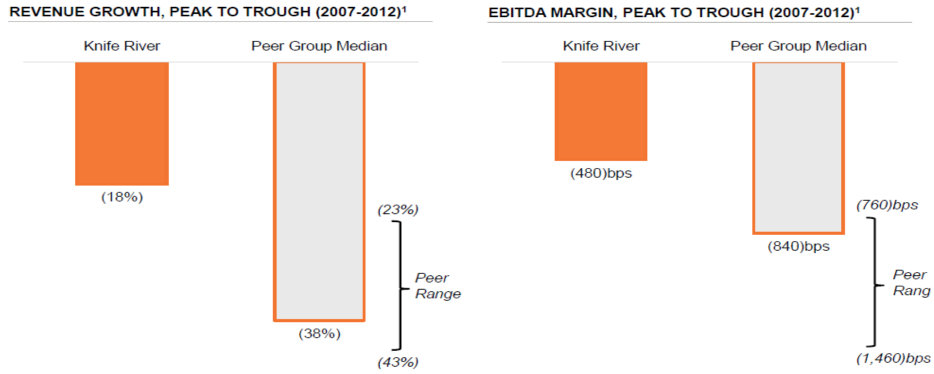
Exhibit 11: KNF is more resilient than peers through a downturn
KNF saw milder peak to trough declines vs peers



Source: Knife River Investor Day

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Knife River's revenue mix is currently 62% materials and 38% services, with material sales well distributed across products. Over time KNF should begin to more closely resemble larger public peers, as the firm continues to place an emphasis on aggregates, and higher mix of materials relative to contracting services over time.

Exhibit 12: Revenue mix last FY
KNF is looking to increase aggregate exposure, and 'grow into' its contracting services business

	KNF	MLM	VMC	SUM	EXP*
Aggregates	16%	62%	67%	28%	10%
Cement/Concrete	19%	26%	20%	41%	45%
Asphalt	14%	13%	13%	11%	0%
Contracting	38%	0%	0%	20%	0%
Other	13%	0%	0%	0%	45%

*YE is June 2023

Source: Company Filings

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Public spending is supportive

Of the 14 states in which Knife River operates, 11 have passed local state funding packages in the last 12-18 months. The passage of the IIJA (exhibit 13) does help drive projects for KNF, however the most important portion of the IIJA is the matching dollars states can secure from the Surface Transportation Investment Program, which provides local jurisdictions with federal funds. As an example, Caltrans (California Department of Transportation) was allocated $14.8bn in IIJA funds towards projects which Knife River will be bidding on. The IIJA also backs larger $200-$500mn projects, which will benefit KNF as a materials provider, and subcontractor to larger firms. Additionally, Texas announced a record $142bn investment in transportation infrastructure, including 10-year $100bn statewide roadway construction plan.

November contract awards remain steady; up 2% YoY

According to ARTBA (exhibit 14), the total value of state and local government contract awards in November was $7.3bn which was up 2% YoY. In our view, this is a proxy of infrastructure construction. On a YTD basis, contract awards are up 9% YoY. More specifically, contract awards are at approximately $115.7bn YTD, 9% above the record levels seen in 2022, and 38% above 2021. Most modes are tracking higher YTD, with Waterways up 107% and Highways & Pavements up 9%, which remains a positive tailwind as we enter 2024.

ARTBA forecasts 2024 contract awards to grow 14% YoY

According to ARTBA's annual market outlook, Highway & Pavement construction is expected to grow at double digits for the second year in a row - reaching $126bn (+16%

YoY) in 2024, with growth supported by early IIJA projects getting to major construction phase and increases in state revenue sources to both match federal funds and provide additional investments. ARTBA projects the total value of overall transportation construction work to grow from $187bn in 2023 to $214bn in 2024 (up 14% YoY - see: Ex. 1). Other sector increases include: Rail & Transit $26.9bn (+6% YoY), Bridge & Tunnel $26.4bn (+17% YoY), Airports $29bn (+14% YoY), and Waterways $5.7bn (+9% YoY).

Limited residential exposure

Knife River has limited Residential construction exposure. Just 6% of backlog as of the time of the spin-off was tied to residential construction. While Knife River does have more exposure to residential construction in the ready-mix concrete business, the firm tends to target higher specification projects vs regionally family-owned peers in their territories, limiting their residential exposure.

Exhibit 13: Approved funding helps drive upside
Federal funding drives local and state budgets

	INFRASTRUCTURE INVESTMENT AND JOBS ACT (IIJA)	AMERICAN RESCUE PLAN ACT (ARPA)	STATE-LEVEL FUNDING
Amount for infrastructure	~$1.2trn	~$194bn	11 of the 14 states where Knife River operates have implemented new funding mechanisms for public projects
Funding description	**New funding** ▪ ~$550bn of new infrastructure spending, with ~$350bn specific to roads and bridges **Renewed funding** ▪ ~$650bn of funding reauthorizations for Department of Transportation **Funding allocations to Knife River states** ▪ ~$131bn of the total IIJA amount allocated to states where Knife River operates	**Total approved funding package** ▪ $1.9trn in COVID-19 relief funding for states, schools and local governments **Funding allocations to infrastructure** ▪ $194bn allocated to U.S. states ▪ $340mm+ of funding dedicated to roadways and bridges	**Select examples** ▪ 2022: • Texas Unified Transportation Program – $85bn • Leading Idaho funding bill – $400mm • Move Ahead Washington – $3bn ▪ 2017: • California Road Repair and Accountability Act – $54bn • Keep Oregon Moving transportation funding package – $5.3bn
Status	Approved & Allocated ✓	Approved & Allocated ✓	Approved & Allocated ✓
Impact on Knife River	Very High	High	Very High

Source: Knife River Investor Day

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Exhibit 14: ARTBA 2024 Market Outlook
ARTBA projects the value of transport work to grow from $187bn to $214bn

Source: American Road & Transportation Builders Association (ARTBA)

BofA GLOBAL RESEARCH

Post spin focus: clearing low hanging fruit

Knife River's Edge framework (exhibit 3) outlines the vision for near and long term margin improvement and value creation. Much of the process is focusing on optimizing internal processes and implementing best practices into the firm's operations. Historically, under MDU Resources, each of Knife River's regions operated largely autonomously, with each making decisions for their territory. Practices varied between regions. Under EDGE, Knife River is centralizing and implementing standardized best practices across territories, leveraging the learnings each region has made, and aligning incentives along margin expansion. KNF's current scale (80+ acquisitions) also allows it enough density to price quality transportation, and price in additional services in a more rigorous fashion than it had historically. Overall, KNF is focusing on two primary levers to drive margin expansion: 1) pricing and 2) cost controls.

Organic initiatives

Pricing

Price has been a point of strength for KNF, with pricing up mid-teens across materials YTD. Historically it was commonplace for price increases to be set once or twice a year via calls to sales/letters/at the scale. This less rigorous process left some price on the table. Knife River is now implementing standardized more dynamic pricing methods. Overall, recent price increases have been more on par with that of peers, with Ready-mix concrete ahead of larger peers. On the contracting side, KNF is bidding on projects with a renews focus on margin profile and forgoing some projects with lower margin profiles.

Exhibit 15: Pricing by product

KNF has maintained pricing in line with larger public peers

Aggregates	2020	2021	2022	9M23	Ready-mix	2020	2021	2022	9M23	Asphalt	2020	2021	2022	9M23
KNF	$ 13.14	$ 13.25	$ 14.61	$ 16.24	KNF	$ 133.86	$ 136.94	$ 151.80	$ 169.02	KNF	$ 48.58	$ 47.86	$ 58.93	$ 66.41
MLM	$ 14.77	$ 15.08	$ 16.68	$ 19.72	MLM	$ 113.57	$ 115.14	$ 128.15	$ 152.79	MLM	$ 48.00	$ 49.96	$ 61.70	$ 65.71
VMC	$ 14.44	$ 14.87	$ 16.40	$ 18.90	VMC	$ 128.93	$ 135.79	$ 150.82	$ 165.27	VMC	$ 57.97	$ 58.83	$ 71.29	$ 75.37
SUM	$ 10.77	$ 11.16	$ 12.07	$ 13.81	SUM	$ 116.47	$ 120.47	$ 136.47	$ 150.66	SUM	$ 59.76	$ 61.05	$ 72.65	$ 84.36
YoY					**YoY**					**YoY**				
KNF		0.8%	10.3%	13.2%	KNF		2.3%	10.9%	13.0%	KNF		-1.5%	23.1%	14.8%
MLM		2.1%	10.6%	20.2%	MLM		1.4%	11.3%	21.9%	MLM		4.1%	23.5%	7.4%
VMC		3.0%	10.3%	16.5%	VMC		5.3%	11.1%	11.0%	VMC		1.5%	21.2%	7.4%
SUM		3.6%	8.2%	16.1%	SUM		3.4%	13.3%	12.5%	SUM		2.2%	19.0%	17.6%

Source: Company Filings

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Cost controls

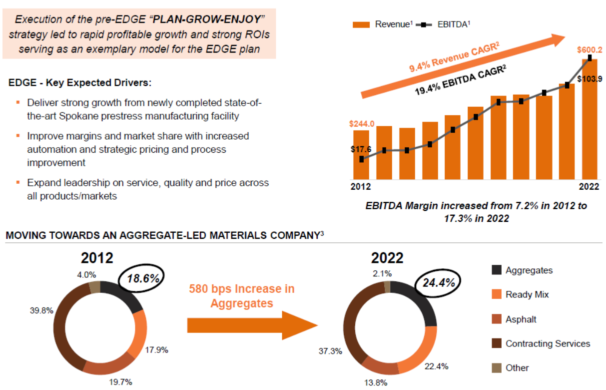
Knife River has formed PIT crews (Process Improvement Teams) across its regions. these teams combine product line experts with regional general managers to form cross sectional working groups. These PIT crews have taken best practice expertise from the various regions and go to each region to standardize and improve processes.

Northwest region a foundation for EDGE

Before the EDGE framework, KNF had implemented an improvement strategy in the Northwest region with notable success (exhibit 16), and which serves as a basis for EDGE. Over the course of a decade from 2012-2022, the region saw revenue grow at a 9.4% CAGR, while EBITDA grew at a 19.4% CAGR. The firm also drive a 580bps increase in aggregate revenue mix in this timeframe, helping EBITDA margin expand from 7.2% to 17.3%. Northwest improvement initiatives are continuing under EDGE.

Exhibit 16: Northwest region roadmap

EDGE evolved from the strategy in the NW



Source: Knife River Investor Day

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Inorganic initiatives: M&A in existing territories

Knife River's markets are highly fragmented. The firm has a long history of M&A, itself formed from a rollup of smaller regional firms. High barriers to entry across aggregates, an unconsolidated market, and KNF's stable cash flow profile align well to further M&A, and Knife River expects to pursue M&A in order to consolidate its position regionally and build scale. KNF has a focus on staff retention and training ('Life at Knife' Program), and maintains strong relationships across the industry, making the firm an acquirer of choice in its operating markets.

Exhibit 17: Recent M&A and investments
M&A and investments have focused primarily on aggregates

RECENT ACQUISITIONS		RECENT INVESTMENTS	
Sweetman Const. Co. **Sweetman (2018)**	• Expanded into strong Sioux Falls area • Added ~55mm tons of aggregate reserves; 3 asphalt plants, 7 ready-mix plants, with a fleet of 61 ready-mix trucks • Since acquisition, saw a 28% increase[1] in revenue and 20% increase[1] in profitability	**Prestress (2023)**	• ~$60mm invested • Expanded market areas to Washington state • Increased scale and efficiencies with existing prestress operations • Best-in-class team delivered improved productivity across the division
Baker Rock (2021)[2]	• Significantly expanded presence in key strategic growth locations surrounding the Portland metro area • Added ~88mm tons of aggregate reserves; 4 asphalt plants • Since acquisition, saw a 60% increase in revenue and 59% increase in profitability	**Honey Creek (2023)**	• ~$63mm invested • Added ~50mm tons of aggregates reserves • Replaces aggregates previously purchased from third parties • Strategically important to serve Texas operations for strong market position

Note: [1] Represents average of first four years of ownership from 2019-2022 [2] Figures pertain to primary quarry site.

Source: Knife River Investor Day

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Management

Knife River's management team has over 26 years of industry experience on average. President and CEO Brian Gray has spent 30 years at Knife River. Mr. Gray graduated from Oregon State and went straight to work for Morse Brothers in 1993 and MDU Resources/ Knife River in 1998 after Morse Brothers was acquired by them. His prior position was as the President of Knife River's Northwest segment from 2012-2022. During his time as President of the Northwest region, the framework which led to EDGE was developed (exhibit 16). Revenue from 2012-22 grew at a 9.4% CAGR, EBITDA grew at a 19.4% CAGR, and aggregate mix increased 580bps from 18.6% to 24.4%.

VP and CFO Nathan Ring has over 20 years at Knife River and MDU Resources and was formerly Vice President of Business Development from 2017-2022.

VP and COO Trevor Hastings has spent over 27 years at Knife River and MDU Resources and was formerly the President and CEO of WBI Energy, an MDU Resources subsidiary, beginning in 2017.

Financial outlook

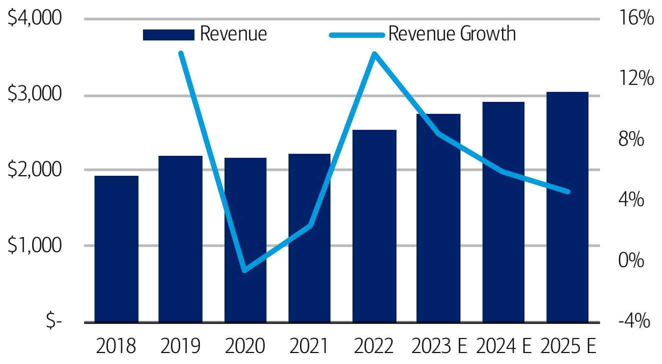
We expect Knife River to hit its 2023 guidance

We forecast Q4 revenue of $567mn (+5% YoY) and EBITDA of $57.4mn (down $8.4mn YoY). This is broadly in line with consensus (sales $562mn, EBITDA $56mn). We forecast EBITDA margin down YoY (10.1% vs 12.2%) in the seasonally volatile fourth quarter given higher expected separation costs in Q4 flowing through corporate support in the 'Other' segment, as well as normalizing in the Energy Service business. The overall impact is expected to be ~$30mn. On a FY basis, our forecasts are in line with EBITDA guidance of $400-430mn (BofAe $420mn).

Recent performance, 2023 guide ahead of expectations

KNF beat Q3 expectations, with revenue, EBITDA, and EPS all well above consensus. 2023 guidance was raised significantly, with revenue of $2.7-$2.8bn raised 2%, and Adj. EBITDA of $400-$430mn raised 17% at the midpoint, driven by the significant uptick in margin. Guidance implies 270bps of EBITDA margin expansion at the midpoint on flattish YoY revenues, vs just 70bps in prior guide. While guidance implies Q4 Adj. EBITDA will down YoY, the impact is from separation costs in Corporate Support vs any impact to pricing (remains positive), backlog (high margin), or optimization efforts. Overall, we find guidance to be achievable given the current level of visibility KNF has, as well as performance to date as an independent entity.

Exhibit 18: Annual Revenue and growth
Revenue has expanded steadily ex-pandemic



Source: Company Filings, BofA Global Research Estimates

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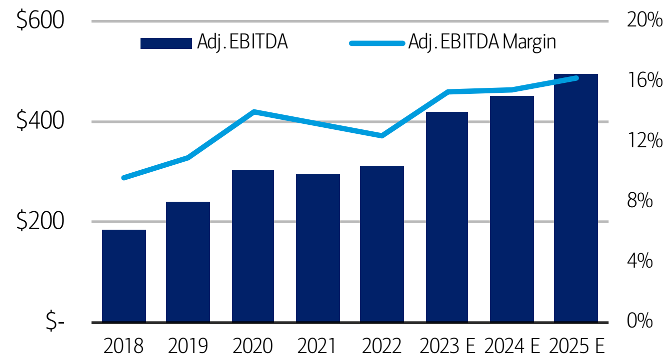
Exhibit 19: Annual EBITDA and margin
Margin gains are set to continue



Source: Company Filings, BofA Global Research Estimates

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Contracting backlog

KNF reports backlog for its contracting services (38% of revenue). 90% of work in backlog is completed within 12 months, with the majority of contracts under $5mn in size (that said, some projects are substantial) limiting risk/exposure. As of now the firm's backlog has significant margin embedded within it. KNF had backlog of $732.2mn as of 3Q23.

At 2025 targets in 2023: we expect ongoing margin expansion

Knife River provided 2025 and long-term EBITDA margin and capex targets at their investor day in May ahead of the spin off. KNF has outperformed expectations the last few quarters as an independent company, with revised 2023 guidance as of Q3 (15.1% EBITDA margin) above that of the 2025E margin target provided (15%). Given the firms execution to date, we have confidence in the long term 20% EBITDA margin targets. A 20% margin on our 2023E estimates would result in around an incremental $1.70 in EPS (vs $2.98 BofAe). Aggregate peers (even those not deriving the majority of revs from aggregates) have EBITDA margins in the 21%-35% range (27% average), further giving us confidence in Knife River's long term target.

Balance sheet

Leverage stood at 1.4x at the end of 3Q23. Knife River's leverage has some seasonality, as the firm ramps capital into the construction season, and then pays down leverage as accounts receivables are collected and inventory rolls off. This means that leverage typically goes above 2.5x into the construction season and then falls below post season, averaging out to around 2.5x annually. Knife River remains committed to remaining at a long-term average leverage ratio of 2.5x and maintains a revolver capacity of $350mn to support the business through these seasonal needs. The firm's consistent cash generation is expected to fund the firm's M&A growth strategy, while any pause in purchases should drive a 'natural' delivering bias. We model FCF conversion of 89% for 2023 ($150mn), with net debt/EBITDA falling to 1.3x (without modelling any acquisitions). In 2024 we model 88% FCF conversion ($165mn). Long term KNF expects capex in the range of 5%-7%, with the majority of spend tied to maintenance capex, with higher usage across the materials side of the business vs contracting services.

Valuation

We see upside to $81

Our $81 PO is based on 11.0x 2024E EV/EBITDA and implies 29% upside to the current share price. Aggregates tend to trade at the high end of the range, with construction contractors at the lower end (exhibit 20). The market places a higher multiple on pure play aggregates such as VMC and MLM trading at 14-16x range. In our coverage, ROAD - more asphalt and road paving contracting work, trades at 11-12x range as its pricing power is more limited vs upstream aggregates. In late November 2023, CRH PLC purchased $2.1bn of cement and ready-mix concrete assets in Texas from MLM at 12.4x EBITDA. Our valuation multiple leaves Knife River at a turn discount to material and construction name ROAD (and the CRH transaction) given limited experience as a public entity and a notable discount (4x) to aggregate pure plays. In our view, several factors underpin KNF's valuation: i) infrastructure stimulus provides funding visibility over the next few years, ii) the business model should see margin improvement on internal initiatives, continuing to have strong cash flow characteristics and inflation protection, and iii) minimal exposure to the more uncertain themes facing Industrials and Materials (China, supply chains, capacity constraints). That said, we do see some risks i) Pricing across concrete and asphalt has moved more in line with peers, ii) internal initiatives are still in the early stages and pose some execution risk, and iii) rates could weigh on housing (and eventually, knock-off impact to non-res) and constrain valuation multiples.

Exhibit 20: Comp table

Our valuation leaves KNF on a discount

	EV/Sales			EV/EBITDA			P/E		
	2023	2024	2025	2023	2024	2025	2023	2024	2025
Martin Marietta Materials	5.0x	4.6x	4.5x	16.3x	14.6x	13.9x	27.0x	24.3x	22.5x
Vulcan Materials	4.3x	3.9x	3.6x	17.0x	15.5x	13.7x	33.1x	27.8x	23.2x
Summit Materials	2.3x	2.2x	2.1x	10.2x	9.3x	8.5x	24.2x	20.2x	16.7x
Eagle Materials	3.7x	3.6x	3.4x	10.7x	9.5x	9.0x	16.5x	14.0x	12.9x
CRH PLC	1.5x	1.5x	1.5x	8.5x	8.6x	8.2x	14.6x	13.8x	11.8x
Construction Partners	1.5x	1.3x	1.2x	14.4x	11.9x	10.0x	40.2x	30.0x	22.7x
Granite Construction Inc	0.7x	0.6x	0.6x	8.5x	6.2x	5.7x	30.6x	11.4x	10.4x
Average	2.7x	2.5x	2.4x	12.2x	10.8x	9.9x	26.6x	20.2x	17.2x
Knife River BBG	1.5x	1.4x	1.4x	10.1x	9.6x	8.8x	20.4x	19.1x	16.6x

Source: Bloomberg

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Price objective basis & risk

Knife River Corp (KNF)

Our $81 price objective is based on 11.0x 2024E EV/EBITDA, which is largely in line with the broad peer group, at a significant discount to aggregate heavy names, and a slight discount to material and construction firms such as ROAD given KNF's limited history of independent operation and still expanding aggregate footprint. In our view, several factors are likely to underpin Knife River's multiple: i) Infrastructure stimulus provides funding visibility over the coming years ii) Improving operating driving margin and earnings and, iii) minimal exposure to the more uncertain themes facing Industrials (China, equipment supply chains, capacity constraints). Downside risks are: 1) aggregates prices and volumes fail to rise as we forecast, 2) bottlenecks (labor, etc.) slow down or push out volume growth , 3) dislocation in rates results in a more broad slow down in construction recovery, 4) price-cost dynamics or operating leverage see limited improvement.

Analyst Certification

I, Sherif El-Sabbahy, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

US - Machinery Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
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	AECOM	ACM	ACM US	Michael Feniger
	Blue Bird Corp	BLBD	BLBD US	Sherif El-Sabbahy
	Caterpillar Inc	CAT	CAT US	Michael Feniger
	CNH Industrial NV	CNHI	CNHI US	Michael Feniger
	Construction Partners Inc.	ROAD	ROAD US	Michael Feniger
	ESAB Corp	ESAB	ESAB US	Sherif El-Sabbahy
	Finning International Inc.	YFTT	FTT CN	Sherif El-Sabbahy
	GFL Environmental Inc	GFL	GFL US	Michael Feniger
	GFL Environmental Inc	YGFL	GFL CN	Michael Feniger
	H&E Equipment Services Inc	HEES	HEES US	Sherif El-Sabbahy
	Knife River Corp	KNF	KNF US	Sherif El-Sabbahy
	Republic Services	RSG	RSG US	Michael Feniger
	Techtronic Industries Co Ltd	TTNDF	669 HK	Michael Feniger
	Techtronic Industries Co Ltd	TTNDY	TTNDY US	Michael Feniger
	United Rentals Inc	URI	URI US	Michael Feniger
	Vulcan Materials	VMC	VMC US	Michael Feniger
	Waste Connections Inc	WCN	WCN US	Michael Feniger
	WillScot Mobile Mini	WSC	WSC US	Sherif El-Sabbahy
NEUTRAL				
	AGCO Corp	AGCO	AGCO US	Michael Feniger
	Cummins Inc	CMI	CMI US	Michael Feniger
	Deere & Co	DE	DE US	Michael Feniger
	Fluor	FLR	FLR US	Michael Feniger
	Jacobs Eng.	J	J US	Michael Feniger
	Kennametal Inc.	KMT	KMT US	Michael Feniger
	Martin Marietta Materials	MLM	MLM US	Michael Feniger
	NV5 Global Inc.	NVEE	NVEE US	Michael Feniger
	Ritchie Bros	RBA	RBA US	Michael Feniger
	Terex Corp.	TEX	TEX US	Michael Feniger
	Waste Management	WM	WM US	Michael Feniger
UNDERPERFORM				
	Allison Transmission Holdings Inc.	ALSN	ALSN US	Sherif El-Sabbahy
	Casella	CWST	CWST US	Michael Feniger
	Herc Holdings Inc	HRI	HRI US	Sherif El-Sabbahy
	IPG Photonics	IPGP	IPGP US	Michael Feniger

US - Machinery Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
	Oshkosh Corp.	OSK	OSK US	Michael Feniger
	PACCAR Inc	PCAR	PCAR US	Michael Feniger
	Timken Company	TKR	TKR US	Michael Feniger

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Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) × (1 – Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5 Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings	**Numerator**	**Denominator**
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt – Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit	**Numerator**	**Denominator**
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap = Current Share Price × Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price × Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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Important Disclosures

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Coverage Universe	Count	Percent	Inv. Banking Relationships R1	Count	Percent
Buy	39	44.83%	Buy	22	56.41%
Hold	18	20.69%	Hold	11	61.11%
Sell	30	34.48%	Sell	8	26.67%

Equity Investment Rating Distribution: Global Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships R1	Count	Percent
Buy	1895	53.62%	Buy	1083	57.15%
Hold	832	23.54%	Hold	454	54.57%
Sell	807	22.84%	Sell	383	47.46%

[R1] Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster[R2]
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

[R2] Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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