Machinery, E&C and Waste

Infrastructure call takeaways: a rare bright spot into 2024

Industry Overview

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Call takeaways: one bright spot in sea of uncertainty

Yesterday, we hosted a call with ARTBA, America's largest and most respected national transportation construction trade group. We came away encouraged i) Infrastructure funding is largely protected from debt ceiling, ii) contract awards +18% YTD – suggests funding is making its way through the system and supports activity next year, iii) ARTBA's forecasts for highway construction +13%/+10% 2023/24 on track. While the 'private' side of construction is uncertain, the 'public' side of construction appears to be one of the few areas to accelerate into 2024. Today, we host industry expert to gauge outlook on the private non-res construction outlook given tightening credit standards.

Infrastructure funding not subject to debt ceiling debate

According to Dr. Alison Black, the Highway Trust Fund that supports core highway, bridge, and public transportation investment would not be impacted by the spending limits being set by Congress for 2024 and 2025. That said, there are two minor areas to be affected: i) some capital investment grants in transit, ii) unspent COVID-relief funding – yet states likely already committed the remaining funds allocated to DoTs ahead of the deadline. The bulk of the incremental $550bn over five years is largely intact.

Highway contract awards +18% YTD provide a tail to 2024

Once states commit funds towards projects, there is a subsequent increase in contract awards as projects are put out to bid, which eventually translates into construction spending (i.e., put-in-place). In 2022, there was a record 25% YoY increase in total state and local contract awards. Dr. Black noted that ~10-12% of that reflects higher material and project costs, however, the number of new projects also increased by 4,700. On a YTD basis, highway and pavement contract awards were $28bn as of April 2023, building off the record 2022. This is an encouraging trend to support higher activity into 2024.

Funding continues to ramp up – likely peaks 2026/2027

The rule of thumb for is that 20% of federal aid committed to projects is outlaid in Year 1, followed by 40-45% of the amount committed being performed in Year 2 as more projects are added and construction work picks up. ARTBA highlights that IIJA funding has been flowing through to the states and expects funding to continue ramping up over the coming years with the peak potentially around the 2026-2027 timeframe bolstered by several years of higher funding levels translating into higher construction activity.

State budgets healthy – yet local risks on watch (receipts)

DoT budgets are healthy post years of stimulus, tax recovery, and diversifying revenue (i.e., registration fees). In aggregate, capital spending increase +16% and expectations for next year is to maintain spending levels with some states likely to increase (CA, FL, IL, TX). A potential risk to monitor – lower tax receipts can weigh on the local level.

BofA hosting private non-res construction call today

We believe the risk in the non-res construction market is more on the private side vs public. Look to our call to gauge backlog and tightening credit impact on 2024.

ARTBA = American Road & Transportation Builders Association

IIJA = Infrastructure Investment and Jobs Act

CR = Continuing Resolution

FAST Act = Fixing America's Surface Transportation Act

DoT = Department of Transportation

EV = Electric Vehicle

Call Takeaways

Core highway and transportation funding not subject to debt ceiling legislation

According to Dr. Black, the Highway Trust Fund that supports core highway, bridge, and public transportation investment would not be impacted by the spending limits being set by Congress for 2024 and 2025. However, there are two areas that could be affected: 1) capital investment grants (i.e., transit investment) of $4.6bn/year, of which $3bn comes via the general fund that could potentially be subject to the spending cap, and 2) the agreement to callback unspent COVID-relief funding (i.e., from the $10bn COVID-relief package for state DoTs). As of the end of April, states have committed $7.7bn, with the potential for the remaining $2.3bn to be called back if unspent before May 31st, 2023. However, Dr. Black believes states may have also committed the remaining $2.3bn given that they were aware of this deadline ahead of time.

Continuing resolution to slightly push projects to the right (but not cancel them)

Despite the overall funding levels being part of the IIJA, they are still subject to the annual appropriations process. If there are delays in passing these bills, states may potentially have access to only ~2 months of transportation funding. Dr. Black stated that the duration of the continuing resolution (CR) is important, as states have weathered short CRs before which only delays projects by a couple of months. The first year of the IIJA (FY2022) was a challenge as states did not have access to most of their full year funding until April 1st, 2022. However, given the short CR this year, states have been seeing the funding flow through much earlier in the year.

IIJA flow-through and state DoT spending process put into context

The passing of the IIJA provides $550bn over five years for highway and bridges investments. During the last year of the FAST Act (FY2021), states had access to $46.4bn for projects under the highway program. During the first year of the IIJA, that amount notably increased to $66.9bn. The process by which the market spends these funds is as follows: 1) states obligate money to projects which then takes a few months to be put out to bid, 2) the construction work on these projects gets performed over several years during which contractors perform the work and get reimbursed from their state DoTs, 3) state DoTs then send these project bills to the US Treasury for reimbursement, thereby leading to construction work ramping up over time. The rule of thumb for state DoTs is that 20% of federal aid committed to projects is outlaid in Year 1, followed by 40-45% of the amount committed being performed in Year 2 as more projects are added and construction work picks up. ARTBA highlights that IIJA funding has been flowing through to the states and expects funding to continue ramping up over the coming years with the peak potentially around the 2026-2027 timeframe bolstered by several years of higher funding levels translating into higher construction activity.

Strong start to highway contract awards (+18% YTD) over a record 2022

Once states commit funds towards projects, there is a subsequent increase in contract awards as projects are put out to bid. In 2022, there was a record 25% YoY increase in total state and local contract awards. Dr. Black noted that ~10-12% of that reflects higher material and project costs, however, the number of new projects also increased by 4,700 – both strong indicators of higher amount of work being performed by state DoTs (proxy for contractor backlog). As these projects get underway, they are translated into put-in-place (PIP) spending (i.e., actual construction spending), which as of April 2023 was up 18% YTD following a record 2022. More specifically, highway and pavement contract awards were at $28bn as of April 2023 vs $20bn over the first 4 months of 2021. Dr. Black finds this trend encouraging as this demonstrates that projects have already been ramping up early this year, and this is before the major construction season begins over the summer.

Federal highway program matching dynamic: federal (80%) + state (20%)

Typically within the federal highway program, federal funding supports 80% of the project cost, and states have to provide 20% to 'match' that amount. Over the past 10 years, states have diversified their revenue streams to support state and local investment. According to Dr. Black, it is not uncommon for states to raise their revenue following the passing of a major federal bill to match federal funding. For example, 13 measures have been approved in 11 states this year to provide $4.4bn in additional revenue. More specifically, Montana, Tennessee, and Utah have installed new EV registration fees, whereas Georgia plans to regulate and tax the electricity used on EVs. Dr. Black noted that a gas tax has not been passed over the past year, but states are expected to revisit their funding mechanisms as federal fundings ramp up.

COVID relief stimulus + IIJA funding to help weather through potential recession

The transportation construction industry can typically weather through a short recession, particularly across highway and bridges investment via on-going project work. However, prolonged recessions could have an extended impact on state and local budgets due to lower revenues/surpluses and lower budgets towards transportation spending. For example, after the Great Recession in 2008-2009, it took almost a decade before highway and bridge spending (adjusted for CPI) returned to pre-recessionary levels. However, the additional stimulus during COVID and the passing of the IIJA significantly helped state and local budgets despite declining transportation revenues. Hence, Dr. Black believes the transportation construction industry is in a notably better position to navigate through a potential recession this time vs prior downturns. Local budgets could be impacted by broader economic conditions as they largely rely on sales tax revenue. However, Dr. Black noted that they have not been hearing any concerns around local finances yet. State revenues (being more diversified) are less susceptible to a slowdown as they largely depend on user fees such as motor vehicle registration fees, license registration fees, gas tax based on gasoline prices, EV registration, etc.

Inflation has been relatively easing across broader construction indices

According to Dr. Black, there has been a moderation in highway and bridge construction inputs in recent months (largely due to the easing in fuel prices). On the other hand, concrete and cement prices have remained elevated compared to 2022. Dr. Alison believes the industry has now adjusted to these higher prices, although broader market uncertainty remains a challenge. While this could mean that lesser number of projects can now be completed for the same amount, inflation does not seem to be eating away all the additional funding as it is not just the dollar amounts of projects increasing, but also the demand in volumes for different construction input materials. More specifically, demand for tons of asphalt was up 7.5% last year vs 2021 and concreate pipes demand was up 10%. Dr. Black stated that this increase in materials demand for DoT projects signals strong growth in the market. In terms of labor, increase in wages for construction workers was up 4% (in-line with the private sector). March was a particularly strong month with 19,000 jobs added compared to 2022. However, Dr. Black believes contractor would be hiring more workers if they were available given the record number of job openings and low unemployment rate in construction, which suggests that there continues to be some stress in the construction labor market.

ARTBA forecasts construction capital outlays up 13% in 2023 and 10% in 2024

According to ARTBA, construction activity is expected to grow by ~13% in 2023 and another ~10% in 2024. Dr. Black expects construction work to increase across all modes, but highlighted strength in rail & transit and airports contract awards in particular, which have now been picking up (with potentially more investments being added going forward due to higher public transport usage) following a notable slowdown in their respective pipelines during the pandemic.

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