Stocks in The Engineering & Construction (E&C) Industry have experienced some wild price swings of late. The S&P 500 Construction and Engineering Industry Index has risen close to 50% year to date. While this industry is highly cyclical, there are many companies that should experience an acceleration from their historic top- and bottom-line growth rates, thanks to government funding.

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M&A Environment

The construction industry is highly fragmented across most regions and sectors. It is usually easier to buy a competitor rather than to build a business organically. While higher interest rates make financing transactions more difficult, tighter lending standards on projects will put more pressure on contractors with a good business, but weaker financials. With the passage of the infrastructure laws in the United States, there is more confidence that the funding mechanism will be stable in the coming years. That said, a potential recession may cause some to pull back in this area. *Stantec*, a design contractor, noted that it is seeing more opportunities to acquire larger competitors. Media reports recently speculated *KBR* could be a potential acquirer of *Jacobs'* critical mission solutions unit for around $5 billion. We don't believe *KBR* is actively pursuing large acquisitions. *Jacobs* may run into some challenges offloading this division to a peer, given the number of sensitive government contracts it handles.

Construction Data

U.S. manufacturing construction spending has risen 80% in 12 months through June, according to the Associated Builders and Contractors analysis. U.S. nonresidential construction spending was up 18.1% year over year, thanks in part to funds from government legislation. There is about $1 trillion that is expected to be allocated across a number of industries through 2030.

The Architecture Billings Index (ABI) reading for July, a leading economic indicator for nonresidential construction activity, showed billings were flat. Billings, inquiries, and design contracts picked up some steam in the spring, but have receded in the months of June and July.

Data Center Demand

The surge in artificial intelligence (AI) applications has spurred investments for data centers. What's more, these facilities are very capital intensive and it is not easy to just retrofit an existing facility. In fact, these AI facilities require seven times the amount of power than a traditional data center, which means that additional power infrastructure is needed. With these AI applications using such a high power load and current capacity at peak levels, we believe the buildout of data centers will be healthy through this decade. According to a research firm, Data Bridge Market Research, investment in data centers and the hardware are expected to grow at a compound annual rate of 44% and reach $420 billion by 2029.

Sterling Infrastructure is well positioned in this area. The stock is trading at an all-time high after rallying substantially this year. While our current projections suggest much of the optimism is baked in, we may be underestimating the strength in the adoption of AI generative applications. *Quanta Services* will be a winner, in our view, as these data centers require more power with the expectation that they will be powered by clean energy. We suspect these investments will put even more pressure on stakeholders to accelerate time lines for transmission and distribution infrastructure work.

Outlook

Projects in several areas that will be impacted by recent federal legislation have been delayed, due to a lack of clarity regarding regulatory rules. In mid-August, the Biden Administration issued final guidance on rules related to using U.S.-made goods and materials. While many of these rules are not new, the Biden administration has included fiber-optic cable, lumber, drywall, and metals to the list of materials that must be at least 55%-sourced from the United States. Contractors will push the pricing on to the customer. We do expect higher costs and tighter lending standards to have some impact on projects moving forward. Regional banks also play a large role in lending.

Nonetheless, the long-term outlook remains favorable. The U.S. government has passed large infrastructure laws over the last two years that should support bidding pipelines and backlog growth. The government is ramping up investments in road work, clean energy, and rural broadband networks. The buildout of advanced technology facilities and data centers are also two megatrends that will remain growth drivers for contractors in the coming years.

Conclusion

The E&C Industry is highly cyclical, and earnings can really fluctuate due to construction mishaps or poor weather conditions. A recession is traditionally not good for this sector, but most of these companies should hold up better this economic cycle given the increased government funding for multiple industries. We continue to like *Jacobs*, as the stock offers above-average capital appreciation potential. We also believe a sale or spinoff of its government business will unlock shareholder value.

Michael Collins, CFA