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2020 Building Products Perspectives and Trends

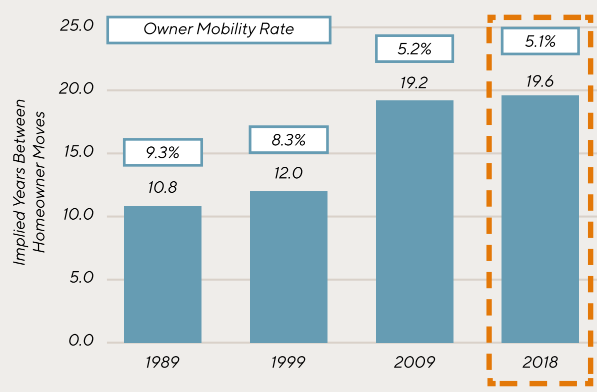
Due to COVID-19, Lincoln International and L.E.K. Consulting had to cancel the annual Building & Infrastructure Conference for 2020. Our hope is that we can host you again in the fall of 2021 in New York City. With the International Builders Show also transitioning to a virtual event in 2021, we thought it was more important than ever to share our perspectives on what we have seen in 2020. The broader residential construction market has performed remarkably well despite the pandemic, and we also have seen several trends accelerate that we expect to continue during and post-pandemic. We look forward to connecting with you again in person in 2021.

Construction Activity Update

After an initial period of disruption to demand and the supply chain, residential building products have been resilient and are experiencing significant growth. The first area to show strength during the pandemic was residential repair and remodel (R&R), which has continued to outperform as a result of a reallocation of resources into the home, where consumers are spending more time. Homeowner mobility has been declining for years; the implied years between homeowner moves has increased from 12.0 years in 1999 to 19.6 years in 2018. While housing turnover has slowed, residential R&R performance has continued to grow as there has been a significant nesting effect. A survey conducted by John Burns Real Estate Consulting recently concluded that the No. 1 reason to invest in a kitchen remodel is that the owner can "no longer stand looking at the current kitchen." COVID-19 accelerated this nesting trend and its impact on businesses exposed to R&R. While residential R&R growth rates are expected to be lower in 2021 versus 2020 due to some project pull-forward that has occurred over the last eight months, there will be significant category variations driven by purchase urgency, average cost and home experience.

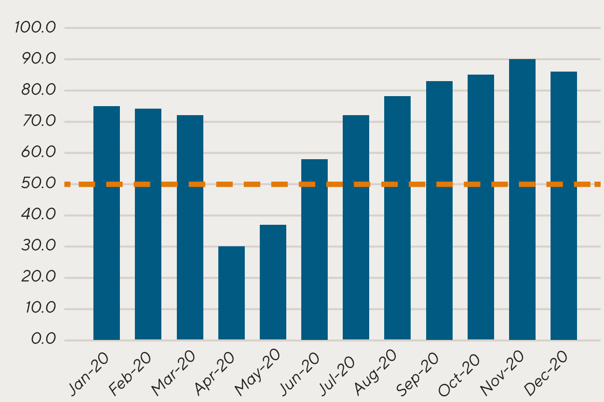
As we moved through the summer of 2020, new residential construction also accelerated as demand for larger single-family houses that are further from city centers increased. The rise in demand has also been coupled with aggressive actions from the Federal Reserve to keep long-term interest/mortgage rates low in addition to higher levels of consumer savings due to lockdowns. The growth in new construction is also driven by demographics as well as COVID-19 factors. A recent Zonda survey found that the number of millennials considering a home purchase has increased from 22 million pre-pandemic to 29 million currently. In contrast, multifamily housing was above historical levels in 2019 but experienced an estimated 10.4% YOY decline between March and September in 2020, as market uncertainty and consumers' desire for more space curtailed many new projects. Total housing starts activity in 2021 could be even stronger as mortgage rates remain at record lows, consumer income and home values rise, and millennial household formations accelerate (although multi-family starts are projected to decline).

Homeowners Move Far Less Often



Sources: U.S. Census, John Burns Real Estate Consulting

Builder Confidence Quickly Recovered and is Making All Time Highs



Note: a score above 50 represents good conditions while a score below 50 represents poor conditions

Source: NAHB/Wells Fargo Housing Market Index

The nonresidential construction market was negatively impacted as the demand for commercial real estate, specifically office structures, struggled throughout the year. While high backlogs provided initial support, the pace of completions and new bookings has since slowed in most geographies. Cumulative U.S. non-residential construction spending fell by 1.8% through November, but then 7.7% in November. Despite broader softness, there were bright spots in warehouse, distribution centers and data centers throughout 2020, which benefited from continued e-commerce trends. While this past year has been a challenging one for nonresidential construction, there are forward-looking indicators like the Architecture Billings Index (ABI) and lending statistics that suggest the industry may be reaching a bottom. The potential for widely available COVID-19 vaccines with high efficacy could lead to an accelerated recovery for the sector later in 2021 or 2022.

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Specific Industry Trends

While the long-term impact of COVID-19 on construction-related end markets is still unclear, trends that were in motion before the crisis are becoming more pronounced and may be accelerating, including the following:

1. E-COMMERCE

Recent dynamics and emerging implications: Online purchase of easily shipped, small ticket R&R projects (<$5,000) has accelerated through the COVID-19 pandemic, with at least some of this increased activity likely to represent a permanent change in buying behavior. E-commerce had been a developing channel for many building product verticals even before the pandemic. In the past year alone, Home Depot's online sales grew 80% versus total sales growth of 13%, while Lowe's online sales grew 106% versus total sales growth of 19%. Similarly, many categories have seen online sales growth fueled by the pandemic; for instance, online paint spend is estimated to have increased by 42% over the year to July 2020 versus 23% growth for in-store sales. Despite this sector-specific trend toward online buying, companies still face three key digital challenges:

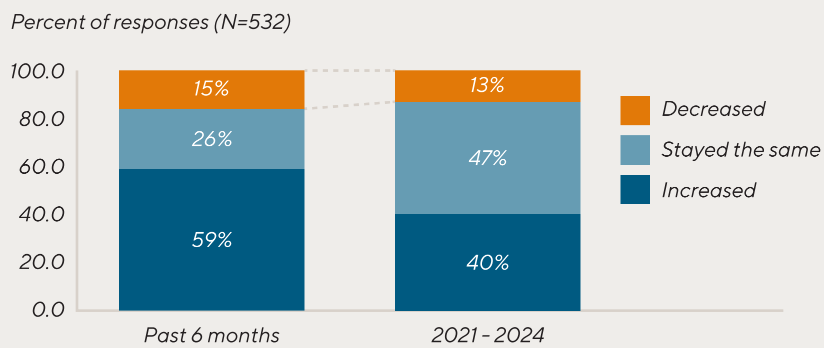
- Manufacturers and distributors must be omni-channel; even before COVID-19, only 50% of consumers' home improvement purchases were store-only and over 50% of residential contractor spending had an online component (online ordering and pickup in store or online ordering and delivery to client location). A 2020 global construction survey found that 75% of engineering and construction companies were planning to increase their spending on digital transformation, implying higher digital expectations from their vendors.
- While manufacturers can sell online or provide online concierge services to consumers, they must weigh higher margins against increased channel conflict.
- Not all companies are investing in their online capabilities. L.E.K.'s research found 83% of more successful companies (defined as those that are taking market share and have high Net Promoter Scores relative to peers) have made a meaningful investment in digital customer experience, while only 19% of less successful firms have done so. Priorities include digital customer and supplier engagement, digital tools for remote selling, digital collaboration in product development and supply chain, and developing a means to address new cybersecurity threats.

› **M&A implications:** Some manufacturers have built powerful digital platforms that can take an omni-channel approach to balancing the concerns of all channels and fostering growth online; companies able to manage this conflict have earned premium outcomes in M&A assignments.

2. OUTDOOR LIVING

Recent dynamics and emerging implications: Even before the pandemic, behavioral trends have shifted toward more habitable entertainment areas in and around the home, including investments into outdoor living as an extension of the livable home space and expansions of overall square footage. With people spending more time at home and the relative benefits / advantages of socializing outside, outdoor living accelerated as a leading home improvement market segment. An L.E.K. September 2020 survey found that 59% of consumers had increased their spending on outdoor living in the prior six months, while a December 2020 Zonda millennial survey found that "I'm looking for a bigger home with a yard" was the second most important reason for move consideration (after affordability) and cited by 30% of respondents. The same L.E.K. survey found that 40% of consumers expect to continue to increase their spending on outdoor living in 2021-24, versus just 12% that expect to decrease their spending.

Customer Expected Change in Spending on Outdoor Living Projects Relative to 2019 Levels
(Sep 2020)



Source: L.E.K. research & analysis

› **M&A implications:** Companies in and around the outdoor living thesis have earned higher multiples in sale transactions as a result of COVID-19, as purchasers are strong believers that the trend is long term and not just a short-term fad attributable to a "COVID bump." We expect industry growth to continue outpacing broader construction activity and still represent an attractive area for investment going forward. Manufacturers and investors who are unrepresented in the outdoor living space can find multiple entry points given the many subcategories, with further opportunities to consolidate product specialists into broader solutions.

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3. MODULAR CONSTRUCTION

Recent dynamics and emerging implications: Labor shortages in construction trades have been a growth constraint for several years and have persisted in 2020. Furthermore, single-family homes are constructed very similarly to decades ago, creating an opportunity for modular construction to help address shortages in construction trades that have been a growth constraint for several years and, despite broader unemployment increases across the nation, have persisted in 2020. However, some caution is needed as modular and semi-modular construction represents only 3%-4% of residential homes today. The Great Recession led to modular construction exits as companies sought strategies that could drive a faster return on capital, and this has started to occur again in 2020 (e.g., Skender, Guerdon) with the Wall Street Journal reporting that Softbank is investing in Katerra to ensure the company's liquidity. Semi-modular construction — prefabricated/prior assembly of selected components — is likely to have the stronger prospects going forward. A 2020 Dodge Data & Analytics survey found that market participants planned to increase their use of prefabricated single trade assemblies over the next three years; meanwhile, major builders are developing capabilities in this area (e.g., Pulte acquired ICG, a provider of off-site framing).

- **M&A implications:** We have seen multiple clients evaluate opportunities that can make their products more job site ready, including factory built/pre-assembled products. There has even been interest in the modular construction space broadly from players outside of what has historically been a niche industry. New construction-focused manufacturers and distributors will need to ensure that they have developed the capabilities to support a more prefabricated world, and that could include acquiring modular or prefabricated capabilities and developing relationships / partnerships with these businesses.

4. CONSOLIDATION IN DISTRIBUTION

Recent dynamics and emerging implications: The decade long run in distribution consolidation is set to continue as Amazon looks to further disrupt traditional routes to market and earn a higher share of the pro customer's wallet, with distribution specialization being a key strategy to limit this impact. Furthermore, larger players that are able to drive industry consolidation have become further advantaged as low-cost distribution models and customer online preferences have accelerated the need to invest in e-commerce and logistics. Manufacturers will need to be thoughtful as they plan for the future, balancing the need for enhanced service to existing channel partners with alternative investment in building downstream property owner relationships, supporting alternative channels or selling direct as a means to reduce dependency on fewer distributors. Distributors can enhance manufacturer and customer support by leveraging new capabilities from consolidation.

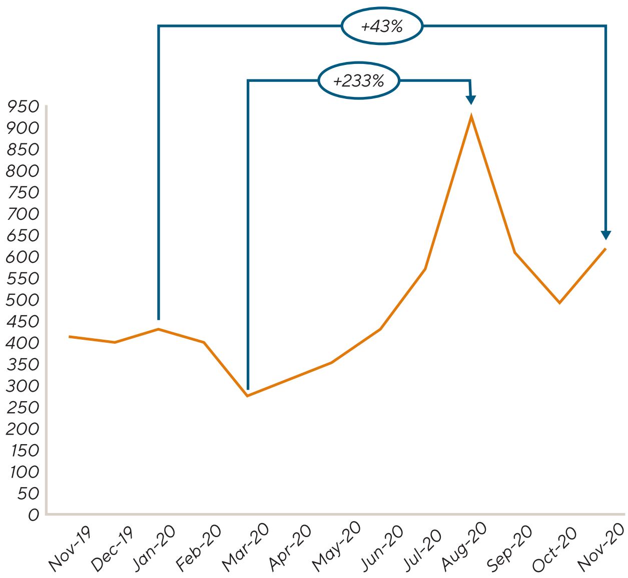
- **M&A implications:** Building and construction distribution had 38 announced or closed transactions from January-December 2020, similar to 2019, but at a record level of transaction values. Even when the HD Supply/Home Depot transaction is excluded, reported transaction values totaled ~$4.8 billion compared with ~$1.1 billion in 2019, representing the highest level of deal value in the last five years. Strong multiples continue to be paid across all verticals of building products distribution; while certain verticals are nearly fully consolidated (e.g., roofing and wallboard), several other verticals remain fragmented (e.g., masonry and landscape products). November 2020 illustrates all flavors of M&A rationales, including serial roll-ups (e.g., SRS's acquisition of C.C. Supply), strategic acquisitions and/or integrations (e.g., Home Depot's acquisition of HD Supply) and private equity investment (e.g., American Securities' acquisition of Foundation Building Materials and subsequent purchase / combination of Beacon's interiors business).

5. INCREASING INPUT COSTS / SUPPLY DISRUPTIONS

Recent dynamics and emerging implications: Industry participants across the spectrum experienced some form of supply disruption in 2020, although many categories did not see meaningful YOY increases in underlying input costs. According to John Burns, 10 of 12 tracked categories saw cost increases below the long-term average, with lumber being a major outlier to this broader trend. Lumber prices have seen a significant rise, increasing by 233% between March and August 2020. While they have retreated from August highs, lumber prices are still up 43% as of the end of November, driven by COVID-19 capacity shutdowns and Canadian tariff effects. At the August cost levels, lumber added ~$16,000 in costs, or ~5%, to median home construction, according to the National Association of Home Builders ("NAHB"). Going forward, lumber production and inventories are expected to continue to catch up with demand, indicating more price stability in the future.

- **M&A implications:** Supplier relationships were significantly tested in 2020. Those relationships that survived a turbulent year and those companies that are vertically integrated have benefited from higher margins and have enjoyed premium M&A pricing versus others.

Lumber Prices per Thousand Square Foot (11/19 - 11/20)



Source: Chicago Mercantile Exchange