Knife River Corporation [NYSE:KNF]

Initiate at BUY at 5.0% | PT: $122.68

October 14th, 2024

CIMG Investment Research

Knife River Corporation: A Cut Above

Knife River Corporation (NYSE: KNF) is a vertically integrated construction materials and contracting services provider headquartered in Bismarck, North Dakota. Founded in 1917, KNF was acquired by the large national utility provider MDU Resources Group Inc (NYSE: MDU) in 1945 and has since rolled up nearly 100 regional companies to become one of the nation's largest construction materials and contracting businesses. On May 31, 2023, MDU completed a tax-free spin-off of KNF, resulting in an independent, publicly traded company. Today, through its network of 180 active aggregate sites, 102 ready-mix plants, and 56 asphalt plants, KNF serves public and private sector customers in 14 states. Its construction materials are sold to public and private-sector customers, including federal, state, and municipal governments, industrial, commercial, residential developers, and other private parties. KNF's contracting services are primarily provided to public-sector customers for the development and maintenance of highways, roads, bridges, and other public infrastructure projects. The company's ~1.1 billion tons of aggregate reserves enable a vertically integrated business strategy with approximately 37% of its aggregates in FY23 being used internally to support value-added downstream products (ready-mix concrete and asphalt) or sold at cost to support the contracting services segment.

Investment Thesis

Migration patterns and infrastructure aging create a disproportionate need for construction services in KNF-operated states. Broadly, American Infrastructure has been worn down and needs immediate repairs. The American Society of Civil Engineers (ASCE) scored American infrastructure as a "C-" in their most recent report card, the lowest grade in the "Mediocre, requires attention" category and only one grade above "Poor, at risk". While this may not seem urgent, beyond the overall score, dams, levees, and roads all scored "D", indicating they had degraded further below the national average. KNF only operates in States that score "C" or below, with the highest concentration in states with a "C-". According to US Treasury data, per capita infrastructure spending is directly correlated to the ASCE score of that state, indicating that the government recognizes supporting states with lower grades as a priority.

Furthermore, KNF's states' respective Department of Transportation's rank as the highest in the country in prioritizing capital spending, including 9 of the top 10 states. Building on this infrastructure spending need, migration patterns also aid KNF's case for new business. CBRE data shows that Americans on the West Coast are moving out of gateway cities (San Francisco, Sacramento, Portland, etc.) and into more rural/suburban areas. This population shift moves people into areas KNF serves. Furthermore, 75% of KNF's revenue is generated from states with a 10-year population CAGR above the national average. InE believes that these combined factors set the stage for elevated infrastructure spending in the regions in which KNF operates.

KNF's vertical integration allows them to severely underbid competitors, earning a larger share of this newly created business. Due to KNF's ability to sell aggregates to its own contracting business at cost, the company can consistently underbid competitors. On the project bids InE analyzed, KNF was ~20% below the second-lowest bid, with the second-fifth bids being within ~3% of each other. Industry experts often criticize KNF for bidding "too low" and leaving margin on the table. An estimator at a rival contracting company was quoted in a Tegus interview saying "They're probably winning too much but at a very low margin. Is that the right way to maybe think about it? I would say no." While KNF has multiple initiatives underway to close the margin gap, InE believes in the short term, this provides the company with an opportunity to rapidly grow its market share and cement its dominance in the Western United States.

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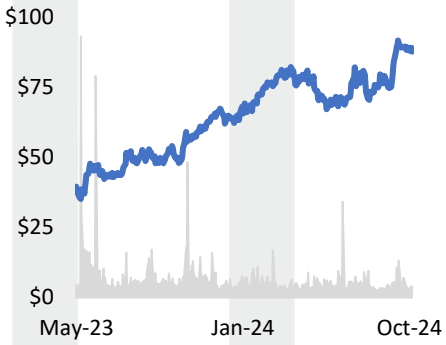
Figure 1: KNF 2 Year Stock Chart



Price	$89.68
Dividend Yield	-
PT	$122.68
Upside	37%
52-Week Range	$46.51 – $93.77
Dil Shrs Outstand	56.81 M
Mkt Cap	$5.04 B
Ent Value	$5.73 B
NTM P/E	24.1x
NTM EV/EBITDA	12.5x

Newly independent management has already grown EBITDA by ~40% in FY23 with multiple levers for further margin gains. While KNF was a subsidiary of MDU, InE found compelling evidence corroborated by former employees, that the segment was undermanaged due to MDU's core business being in an unrelated sector (Utility). In the three years before the spin-off, KNF's EBITDA margins steadily declined, but in the short time since KNF became publicly traded, margins have increased rapidly to above FY20 levels. In FY24, KNF exceeded its FY26 EBITDA margin target, primarily due to the newly implemented EDGE program. Initially tested in the Northwest Region while now-CEO Brian R. Gray was the director of the region, KNF's EDGE program represented a structural change to KNF's approach to the backlog, focusing on higher margin but lower quantity projects that were able to sustain high single-digit price increases on materials. Following the success in the region, Brian Gray became CEO of KNF and implemented the EDGE program in KNF's entire geographic footprint. InE used the success of the case-study region to justify a 20% EBITDA margin by 2026, representing ~300 bps above Street consensus. Finally, InE believes that a lack of a clear competitive set in the public markets has caused the street to value KNF at a discount to both construction and contracting peers, looking past the quality of the vertically integrated business.

Valuation

To model KNF, we used a multiple on the 2026 projected EBITDA. While InE traditionally favors the use of an NTM EBITDA multiple, KNF's backlog is publicly available and priced out accurately through 2025 and therefore, likely already priced into the company's current valuation. Thus, we believe that a 2026 EBITDA multiple allows us to take a differentiated view from the consensus valuation. Using a 10.5x multiple (1 turn higher than the current valuation and still discounted from the peer set), InE arrived at a valuation of $121.96 per share, representing an upside of 37%.

Company Overview

Knife River Corporation (NYSE: KNF) is an aggregates-led, vertically integrated provider of construction materials and contracting services headquartered in Bismarck, North Dakota. KNF currently operates in 14 states across the Western United States, producing and distributing aggregates, ready-mix concrete, asphalt, and liquid asphalt, and providing contracting services to a mix of private and public-sector customers. The company's 1.1 billion tons of aggregate reserves provide the foundation for a vertically integrated business strategy with ~37% of aggregates used internally to support value-added downstream products (ready-mix concrete and asphalt) and sold at cost to support the contracting services segment. In FY23, 77% of KNF's revenue came from public-sector customers and supported various projects such as the construction and maintenance of highways, bridges, airports, and public buildings for federal, state, and municipal governments. The remainder of KNF's revenue comes from various private-sector customers, supporting both residential and non-residential construction end markets. The company was founded in 1917 and was acquired by MDU Resources Group (NYSE: MDU) in 1945. During its ownership, MDU rolled up nearly 100 businesses into the Knife River Brand, expanding the company into 13 new states. On May 31, 2023, KNF Separated from MDU and became an independent, publicly traded company. Today, KNF remains one of few vertically integrated construction materials companies, able to consistently price below competitors to win government contracts.

Industry Overview

Knife River Corporation operates within two distinct comps sets: Construction Materials and Contracting Services. On the construction side, 75% or greater of KNF's aggregates tons sold were in markets where KNF has the number one market position. KNF mostly competes with regional family-owned companies that they have been acquiring, and KNF has very little overlap with national publicly traded industry peers. The Street values KNF in the same comps set as SUM, VMC, MLM, CRH, and GVA. On the contracting side, KNF competes with ACM, FLR, ROAD, and TPC. KNF operates with a cost advantage over all of these companies due to their vertical integration.