Industry Intelligence Report

Mechanical Service Contractors of America

October 2023

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Beacon Economics

About Beacon Economics

Founded in 2007, Beacon Economics, an LLC and certified Small Business Enterprise with the state of California, is an independent research and consulting firm dedicated to delivering accurate, insightful, and objectively based economic analysis. Employing unique proprietary models, vast databases, and sophisticated data processing, the company's specialized practice areas include sustainable growth and development, real estate market analysis, economic forecasting, industry analysis, economic policy analysis, and economic impact studies. Beacon Economics equips its clients with the data and analysis they need to understand the significance of on-the-ground realities and to make informed business and policy decisions.

Learn more at **beaconecon.com**

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1 Industry Overview

Definition

Operators in this industry install and service heating, ventilation, and air-conditioning (HVAC) equipment, as well as plumbing, refrigeration, and other mechanical systems. Contractors may be employer or nonemployer firms and may provide both parts and labor. The scope of services offered includes new work, maintenance, repairs, and alterations. This industry does not include electrical contractors.

Examples of Activities

- Air vent installation and air system balancing and testing
- Blower or fan, cooling and dry heating, installation
- Central air-conditioning equipment installation
- Central cooling equipment and piping installation
- Central heating equipment and piping installation
- Commercial refrigeration system installation
- Plumbing Service

Industry Hierarchy

Level	NAICS Code	Title
Sector	23	Construction
Subsector	238	Specialty Trade Contractors
Industry Group	2382	Building Equipment Contractors
National Industry	23822	Plumbing, Heating, and Air-Conditioning Contractors

Source: North American Industry Classification System (NAICS)

Industry Snapshot

2023 Key Statistics Snapshot

Revenue	Annualized Growth 2013-2023	Annualized Growth 2023-2033
$265.37B	3.7%	3.1%
Operating Profit	**Employees**	**Establishments**
$24.79B	1,377,334	260,858

Opportunities

Industry revenue resilient through headwinds

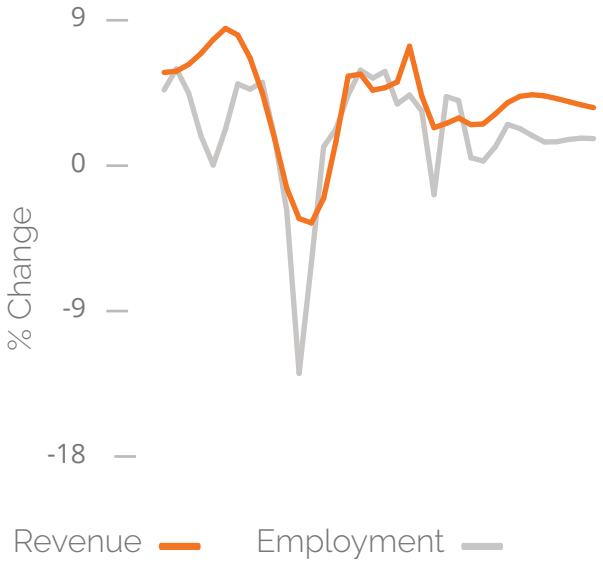
Revenue Growth (% Change)	
2020	0.89
2021	6.79
2022	3.19
2023	2.37

Challenges

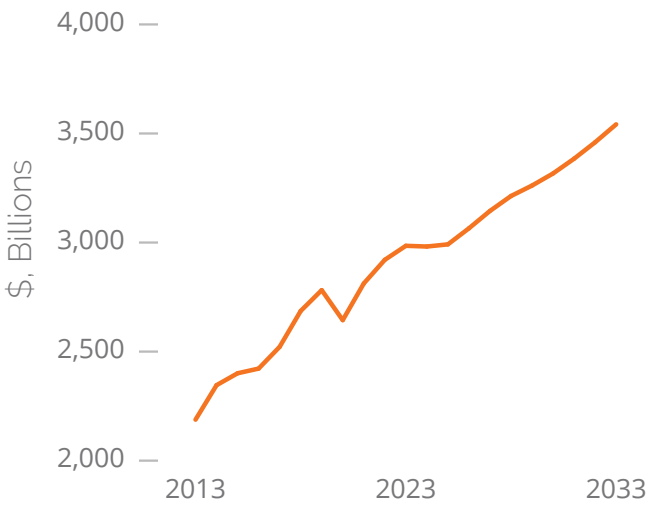
Labor shortages will constrain growth

Employment is expected to increase at an annualized rate of 1.6% over the next 10 years, significantly slower than the 3.5% annualized growth in employment seen from 2013 to 2023.

Revenue vs. Employment Growth



Real Fixed Nonresidential Investment



Source: Bureau of Labor Statistics, U.S. Bureau of Economic Analysis. Forecast by Beacon Economics

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2 Executive Summary

The Mechanical Service Contracting industry is highly dependent on activity in the broader construction sector, particularly industrial, commercial, health care, and other nonresidential construction. Additionally, industry contractors install, service, and repair a variety of multi-family developments. Industry operators' projects have long life cycles from conception to completion, and thus the bulk of mechanical service contracting work tends to occur late in a project's development. This can create a lagged effect whereby the industry experiences the effects of economic trends after an economic cycle begins and, in some cases, long after conditions have normalized. For example, the Great Recession lasted from December 2007 to June 2009, but industry revenue did not surpass its pre-recession peak until 2013. In similar fashion, although higher interest rates have cooled investment, current revenue largely reflects past investment activity. Furthermore, many operators carry substantial backlogs that reflect revenue not yet recognized under contracted or committed installation and replacement project work.

In 2023, Beacon Economics expects industry revenue to increase at a moderate 2.4%, reflecting demand from prior contracted work as well as the repair and maintenance of existing systems. This increase is notably slower than pre-pandemic revenue growth, which averaged around 4.2% from 2013 to 2019. Higher interest rates, supply chain disruptions, and the proliferation of hybrid and remote work have resulted in numerous projects being paused, canceled, or adjusted in scope. For example, in March 2023, Amazon announced it was pausing construction on the second phase of its Arlington, Virginia, headquarters, a project that would have entailed thousands of construction jobs, comprised nearly three million square feet of office space, and spurred many related developments. These kinds of disruptions have constrained revenue growth and will continue to do so in the near future.

2.4% Industry Revenue Increase

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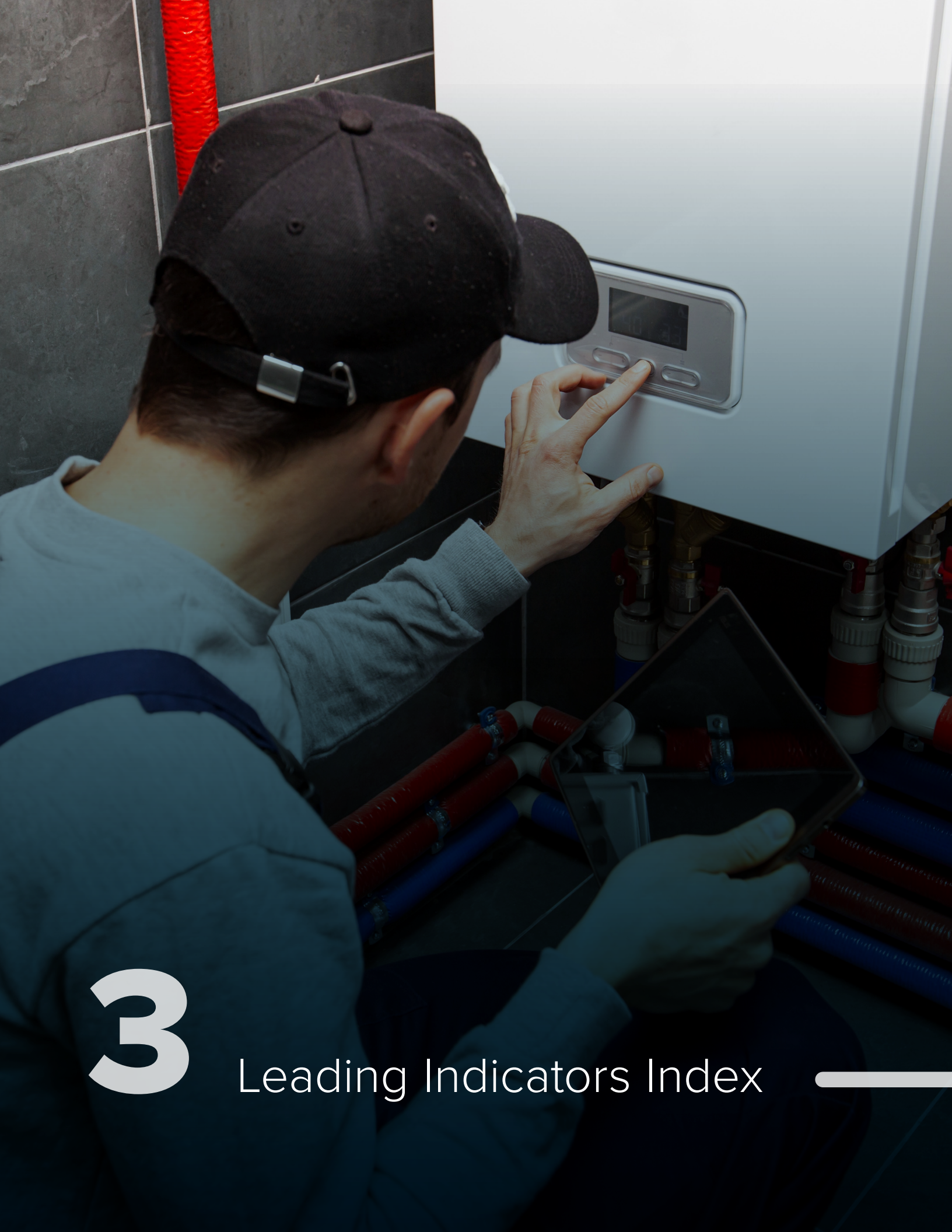
Despite current headwinds, the underlying fundamentals of the industry are strong. The need for dense, multifamily housing in urban areas will drive demand from the residential sector, and the industry will continue to service a diverse array of nonresidential developments. Additionally, aging buildings across the country will need renovation, expansion, maintenance, repair, and replacement services. In general, mechanical service contractors tend to fare relatively well during periods of economic stress as maintenance spending remains constant. As inflation and interest rates cool, these fundamentals will drive growth over the next decade. From 2023 to 2033, Beacon Economics forecasts annualized revenue growth of 3.1%, with employment and establishments increasing an average of 1.7% and 1.5% per year, respectively, over the same period. Nonetheless, labor shortages will pose a challenge for mechanical service contractors, constraining revenue growth and profit margins.

3.1%

Annualized Revenue Growth



3 Leading Indicators Index

Index of Leading Indicators for the Mechanical Service Contracting Industry

Sources: Associated Builders and Contractors, Inc.; U.S. Bureau of Economic Analysis; U.S. Census Bureau; U.S. Department of Housing and Urban Development; Board of Governors of the Federal Reserve System; Index and Analysis by Beacon Economics

This index is comprised of seven leading indicators for the Mechanical Service Contracting industry. Leading indicators help provide early signs of turning points in the industry. The individual components of the index are:

- **Construction Backlog Index**
- **Real Private Nonresidential Fixed Investment**
- **Multifamily Residential Permits w/ 5+ Units**
- **Multifamily Residential Permits w/ 2-4 Units**
- **Core Personal Consumption Expenditures (Core PCE)**
- **Total Private Commercial Construction Spending**
- **Percentage of Domestic Banks Tightening Standards for Commercial Real Estate Loans with Construction and Land Development Purposes**

Construction Backlog Index – The amount of work, measured in months, under contract but not yet performed by commercial and industrial construction contractors. Backlogs will tend to decline during periods of economic stress as contractors continue to deliver services while gaining fewer new contracts.

Real Private Nonresidential Fixed Investment – This indicator measures spending on nonresidential structures, equipment, and intellectual property products. Plumbing, HVAC, refrigeration, and other mechanical systems are integral to most nonresidential buildings. Thus, fixed nonresidential investment signals future demand for mechanical service contractors.

Multifamily Residential Permits w/ 5+ Units – This indicator measures the total number of permits issued to develop and build multifamily residential buildings with five or more units. Thus, when developers acquire permits for multifamily properties, it can indicate future demand for the construction, installation, repair, and maintenance of plumbing, HVAC, refrigeration, and other contracting services provided by industry operators.

Multifamily Residential Permits w/ 2-4 Units – This indicator measures the total number of permits issued to develop and build multifamily residential buildings with two to four units. Thus, when developers acquire permits for multifamily properties, it can indicate future demand for the construction, installation, repair, and maintenance of plumbing, HVAC, refrigeration, and other contracting services provided by industry operators.

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Core Personal Consumption Expenditures (Core PCE) – A measure of prices paid for domestic goods and services, excluding food and energy. Core PCE is a better indicator of overall inflation because it excludes volatile food and energy prices. High inflation can be harmful to mechanical service contractors as it raises construction costs and spurs higher interest rates, which can dampen residential investment.

Total Private Commercial Construction Spending – This indicator measures current spending on buildings and structures used by retail, wholesale, and other service industries. Because it is a nominal measure, it can provide a current snapshot of the impact of interest rates, credit availability, and other factors on the upstream construction sector, which in turn determines demand for mechanical service contractors.

Percentage of Domestic Banks Tightening Standards for Commercial Real Estate Loans with Construction and Land Development Purposes – This indicator measures the extent of credit access and contraction within the building sector. Demand for mechanical contracting services is partly dependent on demand from new development and expansions/renovations to existing developments. In turn, the construction sector is heavily dependent on financing for new developments, and many mechanical service contractors rely on credit to support normal business operations.

After reaching a trough in the second quarter of 2020, the Leading Indicators Index grew steadily through the end of 2021. However, the index has declined for four consecutive quarters since the third quarter of 2022. In the second quarter of 2023, it fell 2.7% from the first quarter and 7.9%

YoY Index Contraction **–7.9%**

year-over-year. The primary culprit for the index's recent declines is weaker permit authorizations from multifamily developers, particularly those with five-plus units. In general, residential development has cooled significantly in the wake of higher interest rates. Additionally, an increasing number of banks are reporting tightening lending standards, including for construction and land development, due in part to the fallout from high-profile bank failures such as Silicon Valley Bank (SVB) in the first quarter of 2023. According to Federal Reserve data, small and regional banks lost about $108 billion in deposits in the immediate aftermath of SVB's collapse, the bulk of it going to the largest 25 banks. Fewer deposits mean less money to lend and tighter loan conditions on money that is lent.

$108 Billion in lost deposits

While tighter credit can weaken demand for mechanical contracting services stemming from new development, it also directly impacts small industry contractors that rely on local lines of credit to support normal business operations. As of the second quarter of 2023, about three out of four banks surveyed reported increasing standards for commercial and real estate loans. What's more, tighter lending can be seen in many other sectors of the economy. A prolonged and deepening credit crunch could lead to business failures and distressed merger and acquisition activity.

While the pace of inflation has slowed, prices are still rising, putting pressure on industry contractors. Fortunately for the industry, nonresidential investment and spending on commercial construction is still rising, and the construction sector's backlog is holding steady at about nine months.

4 Industry Performance

Key Industry Drivers

Industrial Production Index

The industrial production index is an economic indicator measuring the real output of establishments within manufacturing, mining, electric, and gas industries. Industrial establishments rely on a variety of plumbing, heating, cooling, and ventilation systems to carry out operations. Additionally, many industrial operators provide raw or intermediate goods that are used as inputs in downstream industries, such as construction. Accordingly, industrial production is positively correlated with demand for mechanical contracting services.

After strong post-lockdown growth in 2021 and 2022, industrial production has slowed in 2023, particularly manufacturing output, which has decreased due to higher borrowing costs, lower consumer demand, and the need to work down inventories. Accordingly, industrial production increased just 0.3% through the first two quarters of 2023 compared with the first half of 2022. On an annual basis, Beacon Economics expects industrial production to rise 0.1% in 2023. From 2023 to 2033, industrial production is expected to increase at an annualized rate of 0.8%. Long-term and stable growth in industrial production will provide reliable demand for plumbing and HVAC contracting services during the next 10 years.

0.3% Industrial production increase

Real Nonresidential Fixed Investment

Nonresidential fixed investment is an economic indicator measuring the level of spending on structures, equipment, and intellectual property products. Investment in nonresidential structures encompasses new construction, improvements to existing structures, and purchases of used structures. It is of particular importance to mechanical service contractors because it includes equipment deemed integral to a structure, such as plumbing, heating, cooling, and refrigeration systems.

Nonresidential fixed investment rose 3.6% through the first half of 2023 compared to the first two quarters of 2022, driven primarily by strong business investment in equipment. Overall, Beacon Economics expects nonresidential fixed investment to increase 2.2% in 2023, with annualized growth of 1.7% anticipated from 2023 to 2033. Growth in nonresidential fixed investment will spur demand for plumbing and HVAC equipment installation, maintenance, and repair work over the next decade.

3.6% Nonresidential fixed investments growth

Real Residential Fixed Investment

This comprises purchases of private residential structures, including single-family housing investment, and multifamily housing and related equipment that is owned by landlords and rented to tenants. As with nonresidential fixed investment, equipment purchased for residential structures includes plumbing, HVAC, and other equipment and building systems that are installed, maintained, and repaired by mechanical service contractors.

Residential fixed investment declined 17.4% through the first two quarters of 2023 compared with the first two quarters of 2022. Higher interest rates have limited what would-be homebuyers can afford and made it more difficult for multifamily developers to find affordable permanent debt for their construction loans. Slower rent growth in some areas of the county and higher-than-expected construction and operating costs are putting pressure on project economics, causing builders to scale back in response. Annually, Beacon Economics expects residential fixed investment to decline 12.7% in 2023, hampering demand for mechanical contracting work from the residential sector. Over the next 10 years, residential fixed investment is expected to return to growth since underlying fundamentals remain strong, particularly with respect to multifamily – there are still significant housing shortages in urban areas across the country. Beacon Economics forecasts annualized growth of 1.3% from 2023 to 2033.

-17.4% Residential fixed investments decline

5 Industry Competition

Market Share Concentration

Mechanical service contractors operate in a highly fragmented industry consisting of many small enterprises. In fact, the four largest firms generate less than 4% of total industry revenue, and the 50 largest firms account for slightly more than 12% of industry revenue. More than three quarters of industry firms employ fewer than 10 people, and less than 1.5% of companies operating in the industry employ more than 100 people. These figures indicate an industry with low concentration, with no single company or group of companies commanding a dominate share of revenue. Firms employing more than 100 people tend to be large-scale, vertically integrated companies with operations spanning the entire construction supply chain, including fabrication, procurement, design-build, project management, services, and more.

Enterprises by Employment Size

Number of Employees	Share (%)
1 to 4	59.5
5 to 9	18.6
10 to 19	11.6
20 to 99	8.9
100 to 499	1.1
500+	0.2

Enterprises by Revenue

Firms	Share (%)
Four Largest Firms	3.5
Eight Largest Firms	5.4
20 Largest Firms	8.8
50 Largest Firms	12.2

Source: U.S. Census Bureau; Analysis by Beacon Economics

Nonemployers (Share of Industry)

Number of Establishments	Share of Industry Establishments	Revenue ($B)	Share of Industry Revenue
148,681	57%	11.82	4.5%

Source: U.S. Census Bureau; Analysis by Beacon Economics

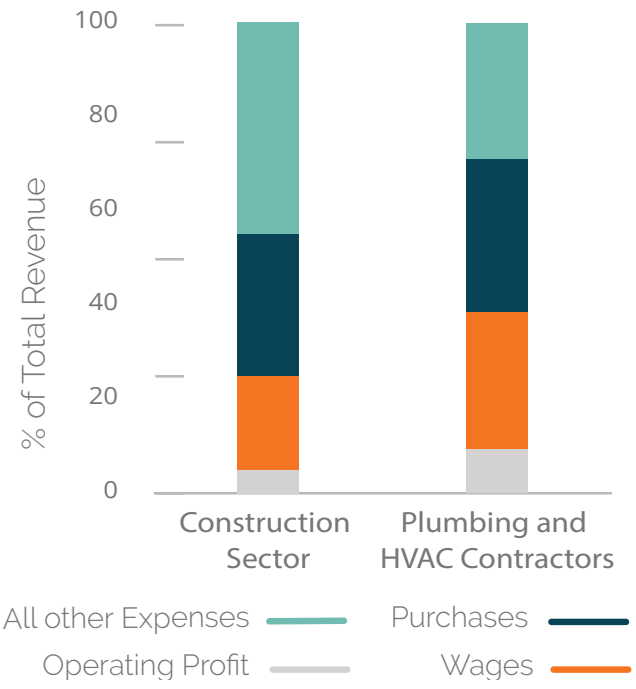
Cost Structure

Operating Profit

Industry profitability is vulnerable to a variety of macroeconomic factors, such as inflation, interest rates, and public and private investment. Moreover, industry contractors establish their prices largely based on assumptions of future macroeconomic conditions, as well as estimates of labor, material, and equipment costs. Given these factors, and the fact that contractors operate in a fragmented and competitive industry where project guarantees are relatively common, industry profitability fluctuates with the cyclical movements of the construction sector at various stages of the building process. Additionally, profit varies depending on the size of the project and whether industry contractors are directly providing HVAC and other mechanical systems.

Operating income is estimated to account for 9.3% of industry revenue in 2023, higher than the sector margin of 4.9%, and reflecting the fact that mechanical contractors are a specialty/service trade. Higher interest rates, weaker demand from residential builders, higher wages, and volatile input costs have all taken their toll on industry profits in 2023.

Sector vs Industry Cost Structure (% of Total Revenue)



Source: U.S. Census Bureau. Analysis by Beacon Economics

Purchases

Non-labor, direct inputs represent the largest component of the industry's cost structure. In 2023, Beacon Economics estimates that purchases constitute 32.4% of industry revenue. Subcontracting fees, which are not classified

32.4%

of Industry Revenue is Purchaces

under wages, are the largest purchase cost for mechanical contractors, accounting for an estimated 7.7% of industry revenue. Nonetheless, subcontracting expenses are much lower as a proportion of revenue than the overall construction sector, reflecting the fact that many mechanical contractors work directly for a company. Power, fuels, lubricants, refrigerants, and other chemicals account for an estimated 6.7% of revenue.

Wages

The level of workmanship can significantly impact the quality and durability of a plumbing or HVAC system. Therefore, mechanical service contracting is a relatively labor-intensive industry. Wages are estimated to account for 29.2% of total industry revenue in 2023. Wage costs are significantly higher relative to the overall construction sector because a larger proportion of mechanical contractors work for a company, rather than as an independent subcontractor. Among wage costs, contractor wages account for 20.6% of industry revenue, while wages associated with administrative personnel and other employees make up 8.6% of industry revenue.

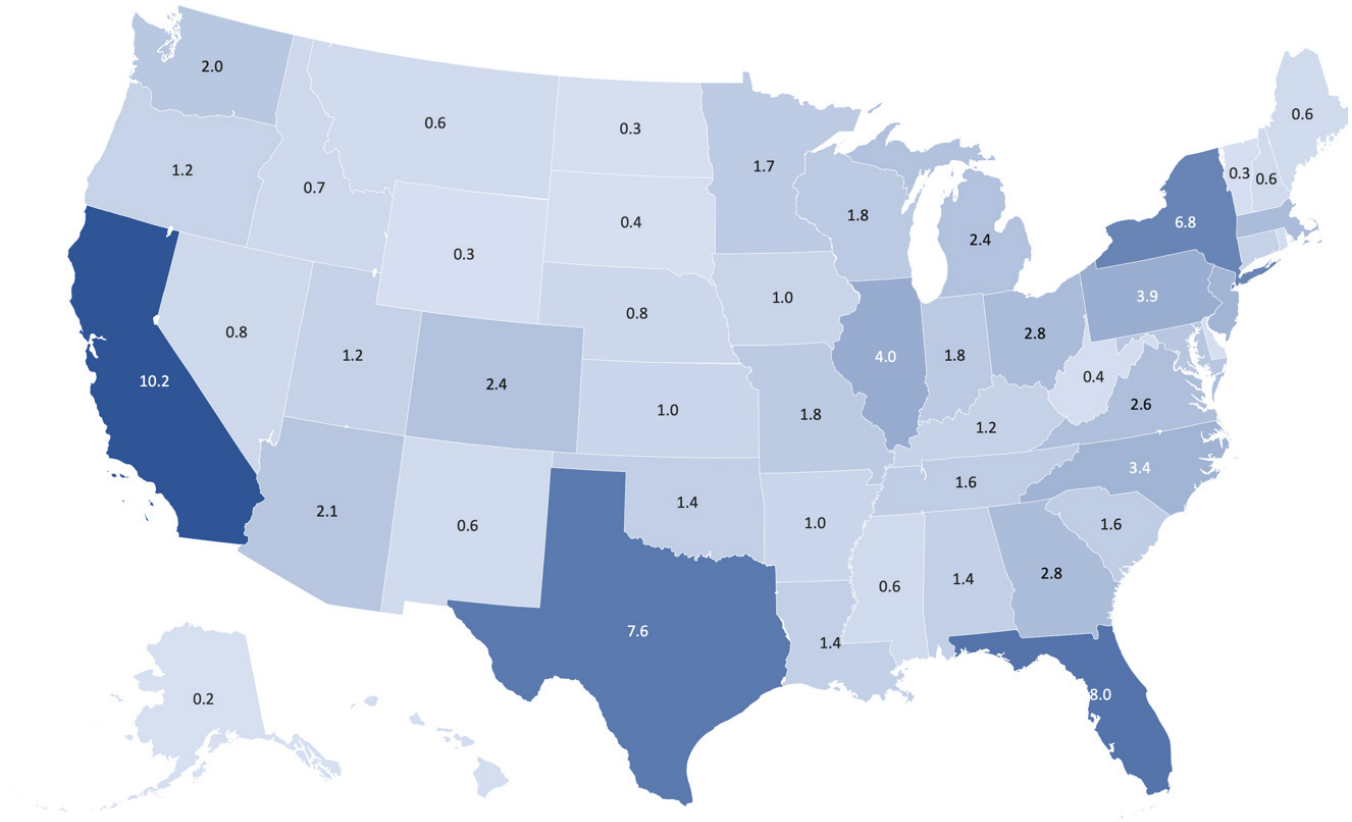
All Other Expenses

Other expenses include rent, utilities, insurance, licensing, marketing, depreciation, and other administrative costs, as well as taxes and other fees and expenses. Collectively, Beacon Economics estimates these expenses account for 29.1% of total industry revenue in 2023.

Geographic Distribution

Industry activity broadly corresponds with the distribution of population and economic activity across the United States. Mechanical contractors are most heavily concentrated in the Midwest and Mid-Atlantic regions. Apart from California, states in the West and Plains regions have the lowest concentration of industry activity. However, this is due to the population and economic activity of each region rather than any regional preference for mechanical contractors. The presence of economic activity and residential development spurs the need for plumbing, refrigeration, piping, and HVAC systems.

Mechanical Contractors (Share of Total Business Locations)



Establishments (%):

0% 10.2%

Source: U.S. Census Bureau; Analysis by Beacon Economics

Revenue, Employment & Establishment Forecast – U.S. Mechanical Service Contractors

Year	Revenue ($000s)	Employment	Establishments
2013	184,749,326	963,814	214,392
2014	195,282,654	1,020,804	217,817
2015	200,125,788	1,076,166	220,976
2016	206,059,744	1,138,926	224,629
2017	214,544,127	1,182,418	227,359
2018	224,505,432	1,234,131	233,256
2019	233,141,224	1,275,830	238,183
2020	235,225,300	1,252,975	242,209
2021	251,208,400	1,306,564	247,915
2022	259,218,300	1,360,480	255,113
2023	265,367,400	1,377,334	260,858
2024	273,245,400	1,394,095	264,860
2025	281,124,300	1,413,955	268,797
2026	289,400,000	1,439,051	272,901
2027	298,133,200	1,466,074	277,153
2028	307,406,800	1,494,766	281,509
2029	316,988,300	1,523,851	285,951
2030	327,136,900	1,552,128	290,421
2031	337,892,000	1,580,213	294,926
2032	349,180,800	1,608,692	299,487
2033	361,052,900	1,637,301	304,111
Annualized Growth (2013 to 2023)	3.7%	3.6%	2.0%
Annualized Growth (2023 to 2033)	3.1%	1.7%	1.5%

Source: U.S. Census Bureau, Bureau of Labor Statistics. Forecast; Analysis by Beacon Economics

Revenue, Employment & Establishment Forecast % Change – U.S. Mechanical Service Contractors

Year	Revenue	Employment	Establishments
2014	5.70	5.91	1.60
2015	2.48	5.42	1.45
2016	2.97	5.83	1.65
2017	4.12	3.82	1.22
2018	4.64	4.37	2.59
2019	3.85	3.38	2.11
2020	0.89	-1.79	1.69
2021	6.79	4.28	2.36
2022	3.19	4.13	2.90
2023	2.37	1.24	2.25
2024	2.97	1.22	1.53
2025	2.88	1.42	1.49
2026	2.94	1.77	1.53
2027	3.02	1.88	1.56
2028	3.11	1.96	1.57
2029	3.12	1.95	1.58
2030	3.20	1.86	1.56
2031	3.29	1.81	1.55
2032	3.34	1.80	1.55
2033	3.40	1.78	1.54

Source: U.S. Census Bureau, Bureau of Labor Statistics. Forecast; Analysis by Beacon Economics

Leading Indicators Index Raw Data (1 of 2)

	Construction Backlog Months	NonRes Fixed Investment $ Billions	Multifamily Permits 5+ (000s, Units)	Multifamily Permits 2-4 (000s, Units)	Core PCE Index	Commercial Construction Spending $ Millions	CRE Loan Standards Percentage
Q1-13	8.0	2171.6	318.3	29.7	101.0	48437.7	3.0
Q2-13	7.9	2177.5	333.0	29.0	101.3	49009.7	1.5
Q3-13	8.2	2214.7	334.0	28.0	101.7	51468.0	2.7
Q4-13	8.2	2260.0	375.0	28.7	102.2	55134.7	4.2
Q1-14	8.3	2291.7	384.7	27.0	102.5	55043.0	0.0
Q2-14	8.1	2353.3	374.3	33.0	103.0	58190.7	4.2
Q3-14	8.5	2400.8	383.3	30.0	103.4	63236.3	1.4
Q4-14	8.8	2415.5	388.7	28.0	103.7	66282.7	1.4
Q1-15	8.7	2412.6	407.0	26.3	103.9	61748.7	5.6
Q2-15	8.4	2423.6	542.3	34.7	104.4	63708.0	4.0
Q3-15	8.5	2432.4	407.3	32.7	104.7	64772.3	13.0
Q4-15	8.5	2412.8	449.0	32.7	104.9	67606.3	11.6
Q1-16	8.7	2410.4	392.3	34.7	105.4	70914.7	16.9
Q2-16	8.6	2426.1	408.0	32.0	105.9	73520.7	24.6
Q3-16	8.5	2457.8	457.0	36.0	106.4	76922.0	34.3
Q4-16	8.7	2473.6	423.7	37.7	106.8	80226.7	30.4
Q1-17	8.3	2499.0	422.7	37.0	107.3	81843.3	26.5
Q2-17	9.0	2524.7	426.3	36.7	107.7	85747.7	32.4
Q3-17	8.6	2544.8	429.3	38.0	108.1	85270.7	17.3
Q4-17	9.5	2601.6	425.7	38.3	108.6	85128.0	7.1
Q1-18	9.7	2657.7	440.3	44.3	109.3	87365.7	14.7

Source: Associated Builders and Contractors, Inc.; U.S. Census Bureau; U.S. Department of Housing and Urban Development; U.S. Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; Analysis by Beacon Economics

Leading Indicators Index Raw Data (2 of 2)

	Construction Backlog Months	NonRes Fixed Investment $ Billions	Multifamily Permits 5+ (000s, Units)	Multifamily Permits 2-4 (000s, Units)	Core PCE Index	Commercial Construction Spending $ Millions	CRE Loan Standards Percentage
Q2-18	8.8	2700.6	443.3	39.3	109.9	85934.0	5.8
Q3-18	9.9	2724.7	418.3	37.0	110.3	82264.0	8.7
Q4-18	9.0	2750.0	435.3	39.7	110.8	76295.0	9.0
Q1-19	8.6	2762.1	440.7	39.7	111.2	75542.3	15.9
Q2-19	9.0	2803.8	443.3	44.7	111.8	77929.3	18.6
Q3-19	8.8	2832.1	522.0	42.7	112.3	82110.7	9.7
Q4-19	8.9	2820.4	522.3	43.0	112.6	85260.0	18.9
Q1-20	8.5	2760.6	442.0	45.3	113.1	88212.3	10.3
Q2-20	7.9	2530.6	413.3	39.3	112.8	86745.0	52.4
Q3-20	7.7	2649.9	456.0	50.0	113.7	82804.3	80.9
Q4-20	7.4	2723.0	458.3	54.0	114.2	84427.3	58.3
Q1-21	7.9	2781.4	536.0	53.7	115.1	86872.7	27.5
Q2-21	8.1	2847.7	517.0	52.7	116.8	91030.3	18.6
Q3-21	7.9	2852.2	587.3	48.3	118.2	94855.3	2.8
Q4-21	8.2	2860.2	633.0	55.0	119.6	101403.7	7.8
Q1-22	8.1	2915.0	615.7	56.3	121.2	109541.0	2.9
Q2-22	8.9	2915.5	655.0	57.7	122.6	115182.7	4.7
Q3-22	8.8	2959.7	668.3	53.0	124.0	120253.3	48.4
Q4-22	9.0	2988.8	605.0	52.7	125.3	123560.3	57.6
Q1-23	9.0	2993.3	582.0	51.3	126.8	122696.3	69.2
Q2-23	8.9	3049.1	502.7	54.7	128.0	123271.0	73.8

Source: Associated Builders and Contractors, Inc.; U.S. Census Bureau; U.S. Department of Housing and Urban Development; U.S. Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; Analysis by Beacon Economics

6 Glossary

Annualized Growth Rate: The average annual growth rate over a given number of years. Annualized growth figures better clarify long-term trends since they remove the unevenness of annual growth rates.

Employment: The count of only filled jobs, whether full or part time, and temporary or permanent, by place of work. (Note: Beacon Economics has added nonemployer establishments to this count).

Establishment: A single physical location at which business is conducted or services or industrial operations are performed. An establishment is not necessarily equivalent to a company or enterprise, which may consist of one or more establishments. (Note: Beacon Economics has added nonemployer establishments to this count).

Operating Profit: A company's profits after deducting operating expenses, such as wages, depreciation, purchases, and other direct and indirect expenses. Analyzing operating income is helpful because it does not include taxes, interest, or any other one-off items that can skew net profit. As such, operating profit reveals how well expenses are managed, and allows for better comparison between multiple companies.

NAICS: The North American Industry Classification System (NAICS) is the standard used by Federal statistical agencies in classifying business establishments for the purpose of collecting, analyzing, and publishing statistical data related to the U.S. business economy.

Nonemployer: A business that has no paid employees.

Purchases: All non-labor, direct expenses associated with the cost of sales.

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