

Why We Own Advanced Drainage Systems

A cloudburst over a car park looks unremarkable until the drains cannot cope. Water pools around doors, roads close, untreated runoff reaches streams and a familiar place becomes unusable. The machinery that prevents this is mostly invisible: basins, pipes, underground chambers, filters and treatment systems designed to move water safely through a developed landscape.

Advanced Drainage Systems, or ADS, makes much of that hidden infrastructure. That makes it an unusually clear example of Delta Outcomes' approach to future-focused global equity: begin with a structural problem, identify the company positioned to solve it profitably, test how adoption becomes earnings and cash, then ask whether the shares compensate us for the risks.

Structural demand below the surface

Rain has always fallen. What has changed is the system it falls onto. Urban development creates more hard surfaces, older stormwater networks need renewal, and heavier downpours can expose systems designed for a different climate and population. When stormwater and sewage infrastructure is overwhelmed, pollutants and untreated sewage can reach nearby waterways.

This is not simply an environmental aspiration. It is an engineering and spending requirement for municipalities, developers, roads, data centres, factories, farms and households. In April 2026, the US Environmental Protection Agency made about \$80 million available through its sewer-overflow and stormwater-reuse grant programme, explicitly citing the threat from ageing and inadequate infrastructure. That funding is only one signal of a much larger, persistent need.

ADS serves that need through two connected businesses. Its Stormwater segment makes thermoplastic pipe and systems that capture, convey, store and treat runoff. Its Wastewater segment, including Infiltrator, supplies onsite septic and advanced-treatment systems where a central sewer connection is unavailable or impractical. The customers include distributors, contractors, engineers, homebuilders and public agencies.

Where it fits. ADS sits within Delta Outcomes' Nature Innovation theme because its commercial purpose is to manage water and materials more intelligently: controlling runoff, supporting water quality and turning recovered plastic into long-lived infrastructure. Delta's other themes are Climate Action and Human Advancement. The themes overlap in the real

economy - flood resilience and sanitation affect both - but we assign one primary classification to keep the portfolio understandable.

Why ADS may win

The investment case is not that every company exposed to water must prosper. ADS still has to win specifications, deliver reliably and earn attractive returns.

Its advantage begins with material conversion. Many stormwater systems have traditionally used concrete or metal. ADS argues that thermoplastic alternatives are lighter, resist corrosion and can be installed faster with fewer deliveries. At its June 2026 Investor Day, management said its products could install two to three times faster and at more than 20% lower installed cost in the applications it compared. Those are company estimates, and the exact advantage varies by project, but they explain why an engineer or contractor might change a familiar specification.

Scale reinforces that proposition. ADS combines manufacturing and distribution with around 300 sales and engineering professionals and more than 3,000 distribution partners, according to the Investor Day materials. Field engineers work with agencies and consulting engineers so products can be approved and specified before a contractor places an order. Once a system has passed technical standards and performed in the field, trust and familiarity can make the relationship durable.

Recycling is also part of the economics, not a decorative claim. ADS processes used high-density polyethylene into feedstock for pipe. Management says recycled material has generally cost 10% to 20% less than virgin material, while Infiltrator's residential chambers and tanks use very high recycled content. Vertical integration can therefore lower input costs and improve supply resilience while giving discarded plastic a much longer useful life.

The acquisition of National Diversified Sales, or NDS, widens the product package into residential stormwater management and landscape irrigation. The opportunity is to sell more of an integrated system through the same channels. The risk is that paying for and integrating acquisitions is much easier than producing durable returns from them.

How adoption becomes earnings

ADS's latest quarter makes the commercial mechanism visible. For the three months to June 2026, company-reported sales reached \$1.001 billion, 20.6% higher than a year earlier. Organic sales grew 9.2%. Stormwater organic sales rose 9.7%, while NDS added \$94.7 million to reported stormwater revenue.

Volume, favourable price-cost management and manufacturing performance helped adjusted EBITDA rise 28.8% to \$358.3 million. Adjusted EBITDA margin expanded from 33.5% to 35.8%, the second-highest quarterly margin in the company's history. In simple terms, higher demand

and a richer product package produced faster profit growth than revenue growth - for this one quarter.

But this was not a clean run-rate quarter. Management said some customers bought ahead of price increases, pulling an estimated \$25-30 million of sales forward from the next quarter. It remained cautious on the overall demand environment. Free cash flow fell to \$203.2 million from \$222.4 million, while net debt stood at \$1.603 billion after the NDS transaction. Those details matter because a strong problem, a good product and rapid quarterly growth do not automatically create a good investment.

Management's longer-term ambition, set out at its June 2026 Investor Day, is revenue above \$4 billion by fiscal 2030, organic growth above 8%, adjusted EBITDA margin above 30% and operating cash flow above 70% of adjusted EBITDA. These are targets, not Delta forecasts. Our work is to judge whether specification gains, material conversion and cross-selling can support those economics through a construction cycle - which is exactly what the next two sections test.

A financially strong business? The honest starting point

A compelling theme only matters if the company behind it can fund it. Here the honest starting point is that ADS's recent financial history is decidedly mixed, not uniformly strong - and we say so plainly before turning to the evidence that gives us some confidence the picture is turning.

Profitability. ADS's return on invested capital, measured on the incentive-plan definition management and the Board use to set pay, averaged 23.0% over the three years to fiscal 2026 - comfortably above the roughly 9% cost of equity we hold it to. A more conservative calculation, however, removes the benefit of management's own add-backs: on that basis, ROIC ran at approximately 16.9% in fiscal 2025 and fell to approximately 12.9% in fiscal 2026, a roughly 400-basis-point decline. That fall was driven mainly by a larger capital base and one-off costs from the National Diversified Sales ("NDS") acquisition - a \$146 million increase in selling, general and administrative expenses that included NDS transaction and realignment costs, and goodwill that grew from \$720 million to over \$1 billion - rather than a genuine weakening in operating performance: adjusted EBITDA still grew 8.3% to \$963 million and free cash flow grew 54% to \$569 million over the same period. Margins tell a similarly uneven story: adjusted EBITDA margin ran at 32.1% in fiscal 2024, dipped to 30.6% in fiscal 2025 on unfavourable price and mix, then recovered only to 31.6% in fiscal 2026 - still below its recent high.

Earnings growth - the case ahead. The historical record does not support the case on its own. Net income attributable to ADS fell for two straight years, from \$510 million in fiscal 2024 to \$450 million in fiscal 2025 and \$426 million in fiscal 2026, and diluted earnings per share fell from \$6.45 to \$5.44 over the same period - even as revenue grew from \$2.87 billion to \$3.05 billion. That is the opposite of the pattern we look for as evidence of quality: profit shrinking

while sales grew, driven by real cost pressure from NDS integration, restructuring and realignment charges, and higher depreciation and interest expense. The most recent quarter points a different way. In the three months to June 2026, ADS crossed \$1 billion of quarterly revenue for the first time, up 20.6% year on year, and adjusted earnings per share rose 27.7% to \$2.49, beating consensus by 18.6%; adjusted EBITDA margin reached 35.8%, its second-highest level in company history. Management was candid that \$25-30 million of that growth was demand pulled forward from the following quarter ahead of announced price increases, and it has guided full-year fiscal 2027 adjusted EBITDA margin to 29.6%-29.9%, down 170-200 basis points, as resin and transportation costs normalise. Sell-side consensus currently expects earnings growth to resume at a double-digit pace over the next several years - a projection, not a settled outcome, and one we will test against actual results quarter by quarter rather than accept on guidance alone.

Shareholder returns - the case ahead. ADS's shares have not delivered the kind of return we would call a demonstrably strong track record: cumulative total shareholder return over the five years to mid-2026 was around 32% - a modest outcome for a five-year holding period, and well short of the sustained, high-single or double-digit annualised returns we look for as evidence of quality compounding. Looking ahead, analysts are constructive - consensus ratings cluster around Buy to Strong Buy, with average twelve-month price targets in the region of \$180, implying upside of roughly 25% from recent trading levels - but a price target is an estimate, not a return already earned. If management's 2030 ambition is realised and the shares' current premium is not itself competed away, the return case improves materially; if margin recovery proves slower or shallower than guided, it will not. This gives us a credible, evidenced path to the returns this thesis needs, though one that is not yet proven in the numbers - a materially different position from a company with an already-demonstrated record.

Leadership we can trust - with a clear engagement priority

ADS's governance culture has real strengths. The Chief Executive and Board Chair are separate people, every director stands for annual re-election, and the company maintains a single class of listed stock with no disproportionate voting rights. Pay is weighted heavily toward variable, multi-year awards tied to stretching financial targets rather than fixed salary, and capital allocation has been disciplined and effective: return on invested capital has averaged around 23% over the past three years, comfortably above ADS's cost of equity, funding a sensible mix of organic investment, bolt-on acquisitions and rising dividends and buybacks.

Set against this, our clearest engagement priority is board independence. Several long-serving directors, including the Board Chair, have served well beyond the ten-year threshold we use to test ongoing independence, regardless of how the company or exchange rules classify them;

on our stricter standard, this leaves the Board and some of its key committees short of the two-thirds independence we look for, and without a genuinely independent Chair or Lead Director. A smaller, related gap is that the Board's own annual effectiveness review is not yet disclosed publicly.

Taken together, this gives us confidence in how ADS pays its people and deploys its capital, alongside a clear and specific ask of the Board on refreshment and independence.

Outcomes as evidence

ADS's Fiscal 2025 Sustainability Report provides scale indicators. The company says it processed 501 million pounds of recycled material and generated 50.2% of pipe revenue from products containing recycled material. It reports more than 13 billion feet of pipe installed globally.

For water management, ADS says the installed footprint of its StormTech chambers can infiltrate more than three billion gallons of runoff, while installed water-quality units can manage more than 11 million gallons per minute during storm events. These are company-reported installed-capacity measures, not independently verified claims about floods prevented or water quality improved in every location.

That distinction is important. For Delta, impact is not a label placed on the company after stock selection. It is evidence that customers are adopting a solution at meaningful scale. The most useful future evidence will connect those installed systems to verified project performance, customer savings, water quality and resilience - and then connect that adoption back to repeatable cash returns.

Value, decision, and tension

We own ADS because three things are coming into line, even if not all of them have fully arrived: a durable, structural need to renew and expand water infrastructure that shows no sign of easing; early but genuine evidence that a weak three-year run of profit and shareholder returns is turning, backed by a fortress balance sheet, disciplined and well-aligned capital allocation, and management guidance we can test quarter by quarter; and a Board with sound structural fundamentals - a separate CEO and Chair, annual elections, a single share class, and pay tightly linked to stretching, multi-year targets - alongside a clear and specific engagement priority around refreshing its longest-serving directors. Few companies we own ask us to hold all three judgements open at once so explicitly.

We do not own it on the assumption that every flood or septic failure it helps prevent justifies any price, that fiscal 2026's revenue growth will repeat without margin give-back, or that NDS will earn back what it cost. The central tension is valuation set against a turnaround still in progress: the market already prices in much of the earnings recovery management has guided to, at a moment when second- and third-quarter margins are set to compress further as resin

costs peak before pricing catches up. A company can be an attractive theme and a mediocre investment if its shares already assume a smooth recovery; discipline on entry price, not enthusiasm for water infrastructure, is what should govern position sizing here.

What could break the chain

A number of things could weaken this thesis, and we watch for all of them:

- Demand and cyclical risk: construction is cyclical. Residential activity responds to interest rates and affordability, non-residential and infrastructure projects can be delayed, and weather changes installation schedules. ADS also faces established concrete, metal and plastic competitors, and its installation and lifecycle-economics claims must continue to hold in real projects. The strong Q1 FY2027 quarter already reflects \$25-30 million of demand pulled forward from Q2, which will make comparisons harder before they get easier.
- Integration and capital-allocation risk: NDS increases debt, goodwill and intangible assets just as free cash flow has been volatile - down year on year in the latest quarter even as \$228.5 million of buybacks continued. Capital allocation deserves continued scrutiny to confirm the balance sheet, acquisition returns and operating needs remain well covered.
- Financial-quality durability risk: the three-year decline in net income, diluted earnings per share and unadjusted return on invested capital has not yet reversed in the annual numbers. A single strong quarter is not proof that margins and profit growth can outpace revenue growth on a sustained basis, and fiscal 2027 guidance itself embeds a 170-200 basis point margin decline.
- Governance risk: four directors, including the Board Chair, remain past the ten-year tenure mark under our stricter standard and hold disproportionate influence over the Audit and Nominating & Corporate Governance Committees. Slow progress on refreshment would leave the Board without an independent Chair or Lead Director for longer than we are comfortable with.
- Impact-case risk: recycled-content and installed-capacity figures are company-reported scale indicators, not independently verified reductions in flooding or improvements in water quality. "Made from recycled material" is evidence to examine, not a conclusion that removes every environmental risk - a complete assessment must also weigh additives, leakage and end-of-life recovery.

The thesis would weaken materially if earnings and cash conversion fail to recover as guided, if NDS proves to have been overpaid for, if board refreshment stalls while long-tenured directors retain committee control, or if verified project outcomes fail to support ADS's own recycling and water-management claims. It would also weaken if the valuation already reflects a smoother recovery than the business can actually deliver.

Owning ADS represents a view that some of the most durable future-focused businesses will be built around infrastructure most people never see - and a considered judgement that its profitability and shareholder returns, though not yet proven over a full cycle, are being rebuilt on a foundation of disciplined capital allocation and pay that rewards the right things. The investment case rests on the causal chain we test everywhere: a structural, unavoidable need for better water management; ADS's material-conversion advantage, distribution reach and specification system converting that need into orders; disciplined capital allocation and improving cost recovery turning those orders into durable cash flow and profit growth; and a Board we can hold to account converting that cash flow into returns for shareholders - not a theme, and not a single strong quarter, alone.

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