3 Reasons We're Overweight Industrials

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The confluence of the strong economic cycle and what we expect will be a step up in capital investment spending suggests a portfolio focus on industrials. In fact, many of our portfolios, especially those that include developed markets, have had significant overweight exposure to industrial industries over the last several years.

The key attribute for any of our company investments is a strong and durable competitive advantage, and industrials have several advantages in this regard, in our opinion even compared with the technology and consumer sectors, which may seem counter intuitive.

Many industrial applications are characterized by hard-to-develop products that require domain knowledge, scale, and manufacturing expertise. Route-to-market, capital allocation, and installed bases are often powerful and durable advantages.

High entry barriers and consolidated markets are also powerful attributes. Industry structure is important since it influences how industrial value creation is distributed and the risk of value destruction. We believe favorable market structures exist in areas as diverse as North American rails, aircraft production, airlines, HVAC manufacturing, and other niche markets.

Here are three attributes of industrials driving our overweight.

1. **Long-Duration Growth**

Although industrial company growth rates may be more modest than the fast-moving technology sector, growth is often more durable and exploitable over long periods. This persistence of growth is what investors tend to underestimate, and where the market is less efficient.

Industrial processes are often complex and have been optimized over many years. Combined with a high risk of failure, this results in strong inertia and risk aversion that slows adoption of new technologies. In contrast, consumer technology is fast-moving as consumers adopt new technologies rapidly in their daily lives. While growth rates are slower for industrial companies, predictability and durability of growth helps companies to exploit opportunities for years, if not decades.

Once a company has built an installed base, typically it provides an attractive aftermarket opportunity that results from demanding operating conditions, safety, and quality considerations. Jet engines are a classic example: the installed base often provides decades of lucrative services and parts revenue for manufacturers. Strong competitive advantages, high switching costs, and customer risk aversion allow for pricing power in many cases.

The increasing focus on environmental and social considerations has strengthened the role of efficiency in the customer value proposition. For many industrial companies, energy efficiency and safety have been cornerstones of their value proposition from the beginning. These companies enable the reduction of emissions and waste through new, more efficient products and engineering-driven solutions.

For example, Spirax Sarco (a manufacturer of products for the control and efficient use of steam and other industrial fluids) recently implemented solutions at a Nestle factory that reduced energy use by 45%, emissions by 43%, and water use by 48%.

2. **Potential for Strong Cash Generation and Value-Creating Capital Allocation**

Industrial companies often generate strong cash flow, which isused to fund value-creating organic and inorganic growth.

Domain knowledge and customer intimacy provide opportunities to develop innovative new products and solutions. These products add value for customers, and long competitive advantage periods allow for the realization of strong returns on capital from the investment to develop these products.

Industrial companies often complement organic growth opportunities with value-creating mergers and acquisitions (M&A). The rationale for acquisitions may include scale, new technologies, and attractive assets in a multi-industry portfolio of businesses.

The top industrial companies have demonstrated discipline by returning cash to shareholders after exhausting organic and inorganic investment opportunities. For example, Atlas Copco (manufacturer of compressors, vacuum solutions, generators, pumps, power tools, and assembly systems) has paid $9 billion in regular dividends over the past 10 years, and on three occasions has paid special dividends worth a cumulative $3.3 billion.

3. **Strategic Use of Financial Leverage**

Long-lived assets and strong competitive advantages allow for the comfortable use of modest leverage to boost returns. Re-leveraging with debt to maintain a constant capital structure is often used to enhance cash flows and returns to equity holders.

The strength of business models and competitive advantages can also provide firepower to flex debt levels higher to capitalize on inorganic opportunities. For example, DSV (a global transportation and logistics company) has used leverage to potentially make highly accretive acquisitions the past several years

The Role of Active Management

Many industrial companies are cyclical and can be volatile stocks. While we are long-term investors, we believe the market tends to overreact to the economic cycles influencing the best-managed industrial companies. This creates opportunities for active managers to deploy capital into mispriced value creators and protect value when the market is too enthusiastic in the near term.

Ken McAtamney, partner, is a portfolio manager on and head of William Blair's Global Equity team.

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