



## Why Industrials Can Be “Growth” Stocks

September 13, 2021

Our overweight to industrials is unique for growth investors, but there are good reasons for it.

These companies offer high barriers to entry, strong and durable competitive advantages, and a long runway for growth. Moreover, environmental, social, and governance (ESG) considerations can strengthen their advantages.

In [an earlier post](#), we discussed three reasons we’re overweight industrials: long-duration growth, strong cash generation and value-creating capital allocation, and strategic use of financial leverage. Here are five more reasons we seek to overweight industrials.

### 1. High Barriers to Entry

Industry structure is important because it influences how value is created and distributed, and how it can be destroyed, and a hallmark of industrial companies is high barriers to entry and consolidated markets.

Railways offer a good example of a highly consolidated market with high barriers to entry. The cost of building a rail network is prohibitive at today’s real-estate prices, resulting in a consolidated market structure with lower overlap on individual shipping lanes.

Favorable market structures also exist in aircraft production, airlines, and HVAC manufacturing.

### 2. Value Proposition Strengthened by ESG Considerations

An increasing focus on environmental and social considerations has also strengthened the industrials value proposition. Energy efficiency and safety have been cornerstones of most industrial companies' value proposition from the beginning.

Many of these companies, for example, are reducing emissions and waste through more efficient products. Consider airlines. Fuel is typically an airline's largest expense, giving these companies high incentives to lower fuel burn. The industry has delivered, with nearly 60% to 70% improvement in efficiency over the past four decades. In a competitive industry, these savings have largely been passed on to consumers in the form of lower fares, which has driven industry growth.

### **3. Company-Specific Drivers Can Add Value**

Idiosyncratic company drivers—including portfolio management, business model transformation, and intangibles such as corporate cultures, brand equity, and process and domain knowledge—can be another source of value creation.

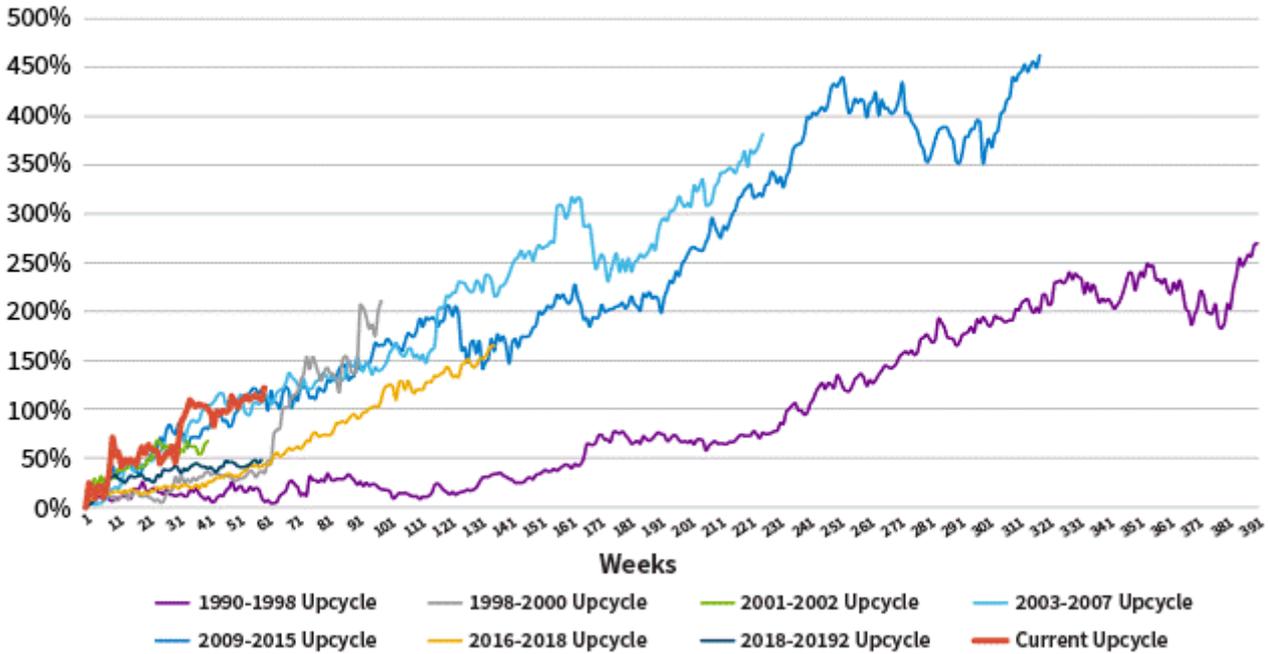
### **4. Stock-Specific Drivers Can Add Value**

Many industrial companies' stocks can be volatile because the market tends to overreact to the economic cycles that influence industrial companies. This can create opportunities for active managers to deploy capital into mispriced value creators and protect value when the market is too enthusiastic over the near term.

Aerospace is a good example. The COVID-19 crisis nearly halted air travel, and market values of aerospace stocks fell 60% in a month. This created a once-in-a-generation opportunity to buy what we believe are some of the best industrial assets in the world at a significant discount to intrinsic value. We expect growth in aerospace to return to trend as health concerns recede and the removal of restrictions releases pent-up demand for travel. Over the longer term, we believe secular growth in aerospace will be driven by a growing middle class in emerging markets, greater affordability, and an overall shift in spending to services.



## Aerospace Upcycle Performance



Source: Bloomberg and William Blair, as of June 2021.

### 5. Strong and Durable Competitive Advantages

We believe the strength and durability of competitive advantages in industrials provides a strong foundation for long-term value creation.

We use a proprietary framework to analyze the competitive advantages of the companies we are considering for our portfolios. This framework is informed by a number of drivers, such as hard-to-develop products that require domain knowledge, scale, manufacturing expertise, route to market, capital allocation, and installed base (a measure of the number of units of a product or service in use).

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