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Industrials

INDUSTRY OVERVIEW

LEXINGWORTH

Brief Introduction

UNDERSTANDING THE INDUSTRY

Firms that operate within the Industrial sector tend to fall under one of 3 groups:

1. The manufacture and distribution of capital (production) goods

   Sub-sectors: aerospace & defense, waste management, construction, engineering & building products, electrical equipment and industrial machinery

   Examples: The Boeing Company (.BA), Lockheed Martin Corporation (.LMT), United Technologies Corporation (.UTX)

2. The provision of commercial and professional services

   Sub-sectors: printing, employment, security, environmental and office services

   Examples: Automatic Data Processing (.ADP), Allegion PLC (.ALLE), The Brink's Company (.BCO)

3. The provision of transportation services

   Sub-sectors: airlines, couriers, marine, road, and rail transportation infrastructure

   Examples: Union Pacific Corporation (.UNP), Norfolk Southern Corporation (.NSC), CSX Corporation (.CSX) .

The vast operational diversity in the above firms signifies that the effects of relevant economic indicators produce idiosyncratic effects in each group. That being said, industrials as an aggregate tend to underpin the economy and therefore average sectoral performance is typically linked to overall economic prosperity and the business cycle.

Sector Analysis

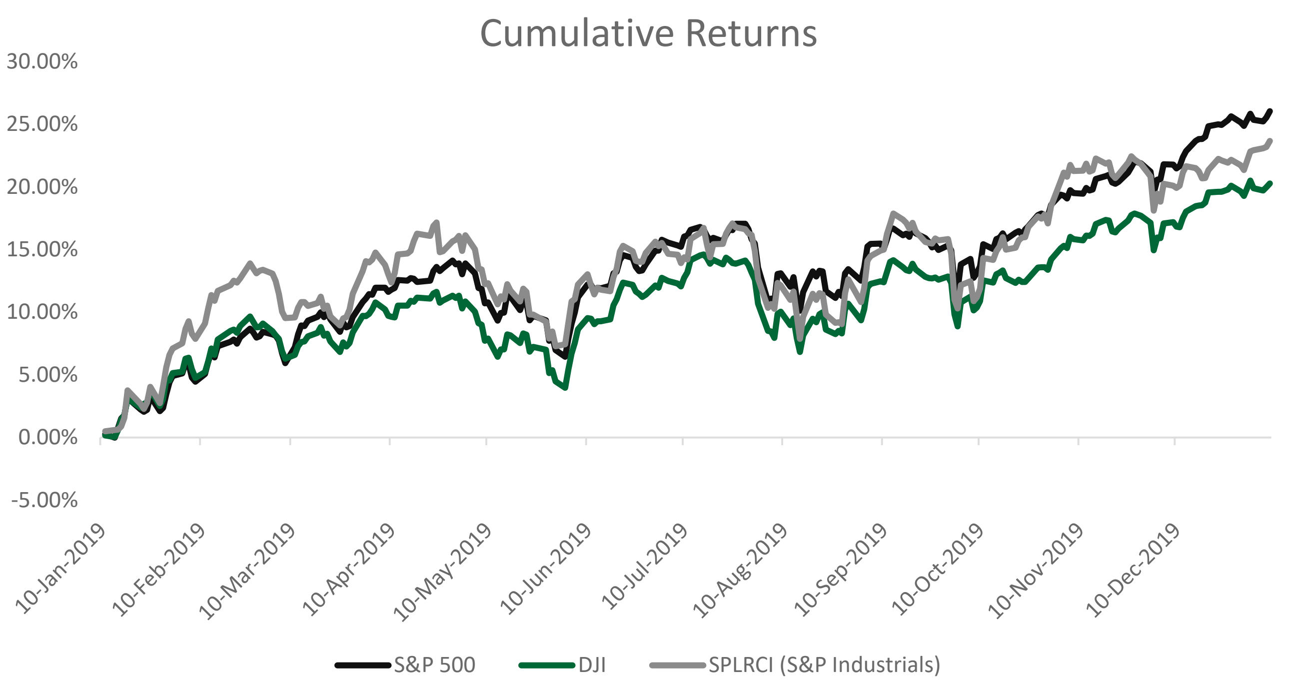
VALUATION OF INDUSTRIALS

Overall, 2019 was a strong year for North American investment performance, supported by a strong labour market, increasing consumer confidence, stimulative actions by the Fed as well as decreased corporate taxes. Despite the positive returns, firms have had to weather many unforeseen, destructive events, some that have yet to fully weigh on growth.

North American Industrials have been one of the sectors most affected by events like the mounting U.S - China trade tensions, significant yield curve inversions, and all-time high (non-financial) corporate leverage. As a result, the sector has underperformed its counter parts and the S&P 500.

Figure 1 contains a comparison between the Dow Jones Industrial Average, the S&P 500 Index, and the S&P Industrials Composite

Figure 1: *Comparison of S&P Industrials to benchmark indexes*



Market Trends

VALUATION OF INDUSTRIALS

Growth-oriented sectors and stocks that benefit from sustained long-term changes, such as Industrials, should continue to outperform, with the price-to-earnings ratio (P/E) of equities moving up marginally over the past year. Since valuations are tied to economic uncertainty, even a partial resolution of the trade dispute would boost valuations significantly, as it would increase corporate investment and industrial production.

Figure 2 showcases the Enterprise value to EBITDA, a popular multiple that is used to measure the value of a corporation and can be seen as a capital structure-neutral alternative for Price/earnings ratio. When valuations of different companies are compared to each other, the enterprise multiple is often considered more suitable than P/E. It is most commonly used to evaluate industrial and consumer industries, currently, the average EV/EBITDA multiple for industrials sitting at 14.10.

Figure 3 outlines the P/E ratios of the highest market cap companies in the Industrials sector. Using P/E ratio for comparative analysis can be misleading due to different amounts of leverage, different accounting practices related to depreciation and different tax rates. Nonetheless, it is still used by investors and analysts to help determine relative value. The average P/E multiple for industrials is 22.75.

Figure 2: EV/EBITDA Multiples for Industrials

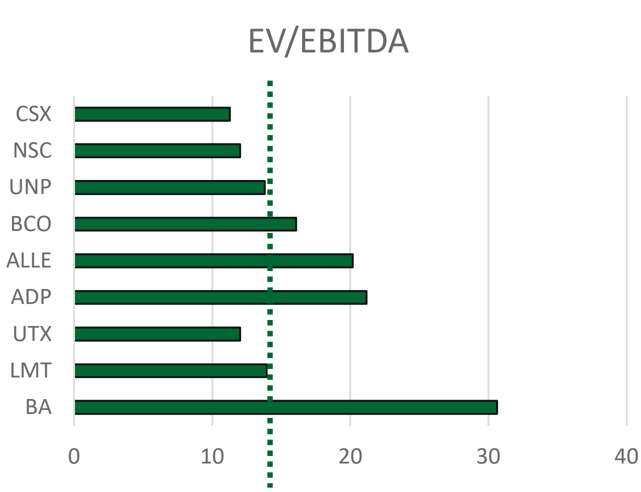
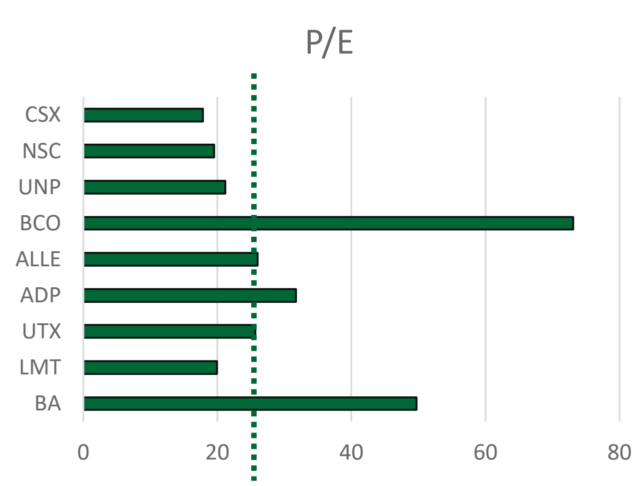


Figure 3: P/E Multiples for Industrials



Market Trends

SUB-SECTOR ANALYSIS

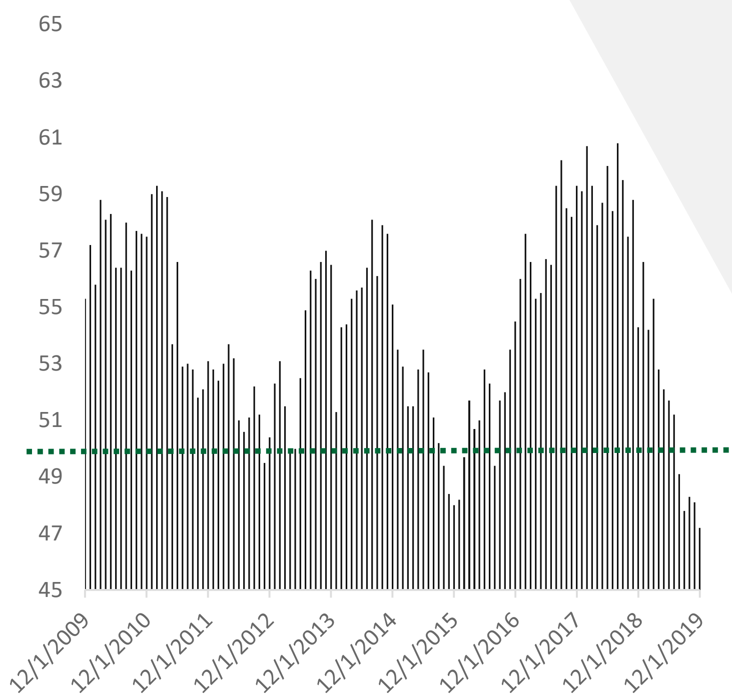
1. **Capital Goods:** Performance is strongly correlated to the business cycle because it relies heavily on manufacturing.

- A key indicator for the state of manufacturing is the ISM Purchasing Managers Index. It is a diffusion index that was created to track the business conditions as viewed by purchasing managers.
- Simply put, when it is reported above 50 manufacturing is believed to be expanding and when it is below 50, manufacturing is believed to be contracting.
- It can be seen in **Figure 4** that as of October 2019, the index has been below 50 and, in December it sunk to its lowest point in 10 years. It can be deduced that the ongoing US-China trade war has made a significant impact to the purchasing managers confidence, and with a phase-one agreement scheduled to be signed in January, many investors are hopeful that a PMI rebound will occur.

2. **Commercial and Professional Services:** Strongly linked to the business cycle as well as the Job Market.

- The Conference Board Employment Trends Index aggregates 8 indicators that track employment trends.
- Since July 2018, the index has been stagnant and just below 110.
- This is a significant contrast to the consistent increases that occurred over the last 10 years.

Figure 4: Purchasing Mangers Index



3. **Transportation Services:** Like the other sub-sectors, its performance is dependent on the business cycle, but also oil prices.

- As we enter a later stage of the business cycle, margins have tightened causing the earnings and valuations of many transportation firms to deflate.
- Oil prices have seen volatility caused by geopolitical tensions, and regulatory pressures.

Industry Trends

WHERE THE INDUSTRY IS GOING

New Technologies & Digitization

- The pace of change, mostly involving new technologies, is causing companies to re-examine their planning process.
- Organizations have to re-examine some of their priorities and key assumptions around longer-term strategy on a more frequent basis.
- Companies are committing US$907 billion per year — about 5 percent of revenues toward greater connectivity and smarter factories.
- Significant portion of new sales growth will come from connected equipment that can exchange data with other machines and computers in real time.

ESG Growth

- Corporate social responsibility is increasingly important for industrials.
- “Social Supers” experienced higher profits and show commitment to improving the world, as societal benefits are fundamental to the businesses and contribute to overall profitability.
- Experiment with multiple renewable energy sources.
- Generational shift is driving awareness and demand for sustainability initiatives creating significant value to employees, communities and shareholders.

Industry Trends

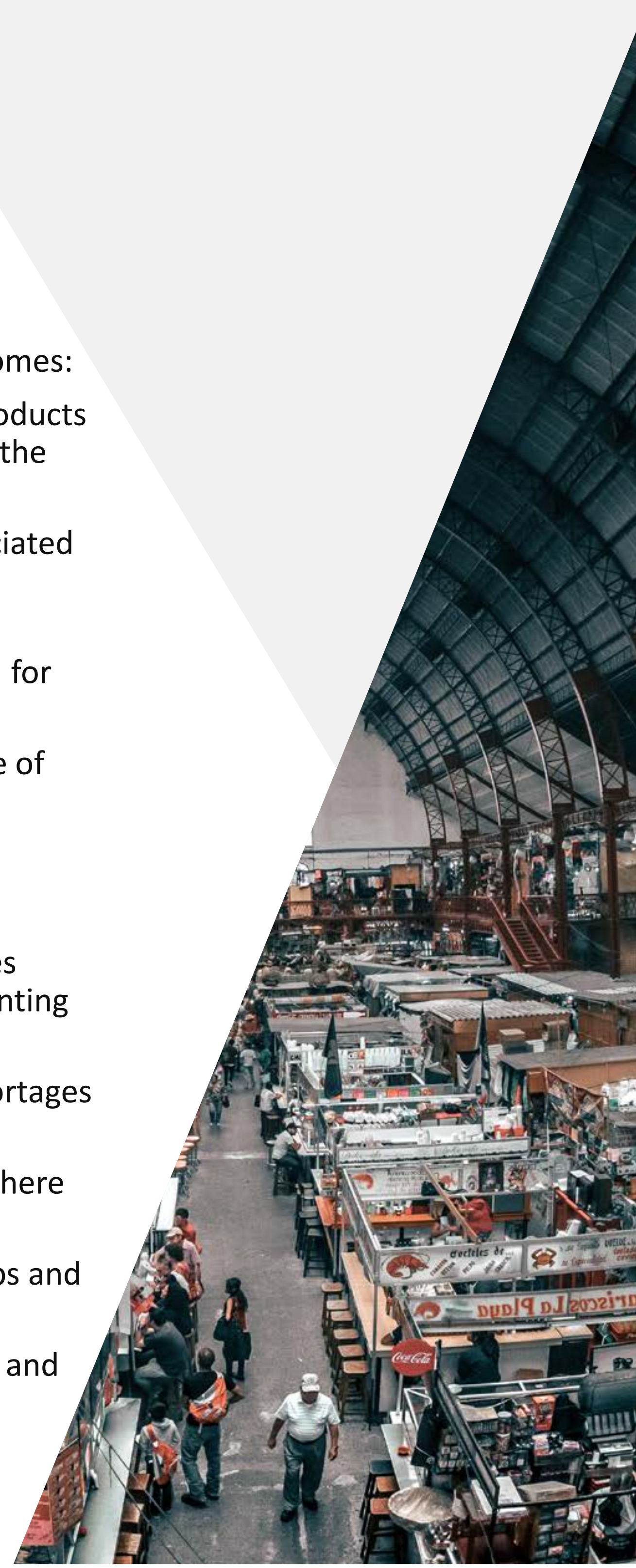
WHERE THE INDUSTRY IS GOING

Spin-offs and Divestitures

- Companies divest unneeded parts of diversified product portfolios to achieve a number of outcomes:
- Free up capital to invest in R&D of disruptive products and emerging tech, enabling revenue stream in the future.
- Connecting highly engineered products to associated services.
- New digital divisions will help inject more entrepreneurship into the organization to allow for higher multiples, similarly to a tech company.
- Streamline operations and double down on core of the portfolio.

Ambiguity and Uncertainty

- Uncertainty is becoming a norm, with companies addressing uncertainty successfully by implementing strong strategic plans and core values.
- Main causes: inflation , tariffs, skilled labour shortages as well as political uncertainties.
- Slows down long-term capital investment until there is stability.
- Opportunity exists to forge stronger relationships and focus on super-serving customers.
- Increase of resilience in operations, divestitures and partnerships.



Future of Industrials

WEATHERING THE STORM

- Overall, economic growth is forecasted to be subdued, but we believe Industrials will fare better in 2020 than 2019.
- Uncertainty is likely to continue into 2020, and thus manufacturers' optimism has experienced a noteworthy setback. Compared with the 2018 Manufacturers' Outlook Survey report, which noted 93.9 percent of manufacturers had a somewhat or very positive outlook on business, the Q3 2019 report shows that just 67.9 percent are optimistic, with the remaining 32.1 percent having a negative outlook.
- In addition to manufacturer's confidence, there are a number of recessionary precursors like yield curve inversions, margin pressures, stagnant U.S. corporate profit, high North American corporate debt, and interest rate cuts that have transpired and caused the sector to be well-positioned for growth in the circumstance of a rebound.
- The coming year promises to be an ever-changing environment for Industrials as they try to regain their footing amidst continued volatility in costs and policy decisions. While the potential for uncertainty may continue for the foreseeable future, business leaders should exhibit resilience in their operations and double down on the core of their portfolios. Levers to support this include building "digital muscle" across areas like the supply chain, mobilizing partnerships within their ecosystem to drive targeted business goals, and leaning into corporate social responsibility.

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