



# Industrials

## Selectivity is Key

**SUMMARY** At Janus, our goal is to deliver alpha by taking an in-depth approach to fundamental research. We extend this commitment to our clients and partners by providing access to the insights and opinions of Janus' seven global sector research teams via monthly analyst interviews. In this edition of *Analyst Viewpoints*, Janus' Ken Spruell discusses the industrials sector with Client Portfolio Manager Adam Schor. Spruell offers his perspectives on variances in end-market demand, the important role of China and the critical factors to identifying long-term investment opportunity in the sector.

### Q: WITH THE SECTOR AMONG THE TOP PERFORMING AREAS, ARE INDUSTRIALS STILL ATTRACTIVELY PRICED?

**Ken Spruell:** As a group, industrial valuations are slightly above the historical trend, which is prompting us to be very selective in the sector. This has been supported by the fact that despite strong third quarter earnings reports, many of these stocks haven't really moved much in terms of price appreciation, a common symptom of somewhat extended valuations. It is also apparent in many stocks' discounted cash flows, which we believe have less potential upside than 12-18 months ago.

That being said, we are still finding opportunity in industrials, particularly in out-of-favor segments, such as construction and in certain foreign markets. For example, we think there's significant potential in several overseas companies that typically don't garner a lot of investor attention.

### Q: WHERE ARE THE INVESTMENT OPPORTUNITIES IN THE SECTOR?

**Ken Spruell:** Currently, there's a wide range of extremes within the sector's multiple end markets, and this is creating both opportunities and challenges. At one end of the spectrum, there are incredibly tight markets where industrial companies have anticipated a slow but steady growth environment and have been slow to hire and increase capacity. Yet their markets have come back faster than expected. An example of this is in the mining equipment industry. The lead time to obtain mining equipment is now up to 10 months.



**Ken Spruell, CFA**  
Equity Research Analyst,  
Industrials

### KEY POINTS

- Sector valuations are somewhat extended, but select opportunities remain.
- Given the difficulty of product differentiation, market scalability and cost competitiveness are critical, especially with the rise of China.
- We think out-of-favor construction companies and certain foreign markets may be trading at attractive levels.

At the other end of the spectrum is the U.S. residential construction segment, which has faced a tougher environment and has been stuck bouncing around a market bottom. Although there have been some recent early indicators of improvement, companies that serve this market haven't benefited from any potential recovery signals yet, in our opinion.

**Q: WHY ARE COMPANIES THAT HAVE EXPERIENCED A STRONG MARKET REBOUND STILL RELUCTANT TO HIRE AND INVEST IN THEIR BUSINESSES?**

**Ken Spruell:** These firms remain cautious because the 2008 downturn hit them with such velocity. Between 2003 and 2008, industrial firms invested heavily in their businesses, building up sizable fixed costs to expand capacity. That trend completely reversed itself in 2008, as firms were forced to cut fixed expenses significantly and quickly rationalize cost structures. Based on concern about the sustainability of the recovery, these companies want to avoid being caught in that position again in case the economic expansion falters.

**Q: INDUSTRIALS ARE OFTEN VIEWED AS AN INDICATOR OF OVERALL ECONOMIC ACTIVITY. CAN YOU EXPLAIN?**

**Ken Spruell:** We think industrials often offer an effective barometer of overall economic activity. If these companies' markets continue to show signs of solid growth or begin to recover at a faster rate, these firms are likely to become more sanguine and increase business investment. The biggest area of impact would be on unemployment levels. While it probably would take three to six months after the signs of solid growth, these firms would start hiring again, which would be, without a doubt, positive for the overall economy.

Unfortunately, there simply isn't a lot of strong economic activity in developed markets right now, especially in the U.S. Europe is growing only slightly, but the fact that it is expanding at all is an encouraging surprise given the austerity measures in many of these countries. Most growth has been coming from emerging markets, which has been a source of strength benefiting these firms, generating approximately an average 20-25% of the sector's overall revenues.

**Q: WHAT ARE SOME OF THE COMMON MISPERCEPTIONS ABOUT INDUSTRIAL COMPANIES?**

**Ken Spruell:** One of the most frequently misunderstood things is the reality that many industrial companies do not have incredibly strong product advantages. These aren't highly differentiated products, such as in healthcare or

technology where billions of research and development dollars have gone into product design. In industrials, most products don't have patented competitive features and are usually easily copied by other firms.

The way these companies distinguish themselves is through business model strength. To capture cost efficiencies, many successful firms either create scale in established markets like the U.S. and then expand overseas or, alternatively, build up scale in fast-growing regions such as China to generate local distribution synergies. Examples of the latter include firms such as Emerson, in the case of heating and air conditioning compressors, and United Technologies, in the case of elevators. Both are market share leaders in China with strong regional presence, and this scale advantage in China provides a scale advantage globally that gives both firms competitive cost benefits.

In addition to market scalability, some businesses have focused intently on differentiating their service models and have created robust distribution networks over decades and, in select cases, more than 100 years. Parcel delivery firms, such as UPS and FedEx, as well as other companies such as the North American railroads and Praxair, an industrial gases firm, have incredibly strong service-focused business models that make it difficult for other businesses to compete. For instance, DHL spent roughly \$1 billion when it tried to enter the U.S. market dominated by UPS and FedEx. Ultimately, however, the firm found it just couldn't compete and wound up exiting after a few years.

Identifying these types of durable competitive advantages is paramount to the Janus research process because we can then model and forecast free cash flows, returns and discounted cash flow valuations to determine whether current stock prices offer a good investment case or not. We also examine select opportunistic investments when companies experience significant restructuring. These firms may not have had the best business models in the past, but we might identify other areas of investment potential, such as an industry primed for consolidation that could lead to a more competitive environment. This is one of the themes unfolding in the automobile industry. Ford is a prime example of a company that hasn't offered the best business model in the past but has experienced significant changes that would be expected to improve returns and cash flows.

**Q: HAS THE SECTOR OFFERED ANY INVESTMENT SURPRISES THIS YEAR?**

**Ken Spruell:** The strength in Europe definitely has been unexpected. When austerity measures began to be implemented this spring, many industrial management teams

expected negative GDP growth in Europe. This hasn't been the case, and one of the main reasons is because of Germany's export economy. As I mentioned earlier, emerging market growth has remained solid, and these countries have kept product demand from Germany high. This has boosted the German economy, as well as all of Europe, since Germany is viewed as the largest and most important economy in the region.

Another area of surprise has been the strength in air freight markets so far this year. This is again a result of emerging market demand, but it is also driven by companies' cautious hiring and capital allocation decisions. Most firms have been very conservative in managing cash flows, keeping inventories low and utilizing just-in-time fulfillment techniques. When business picks up even a little, they rely on air freight providers to help manage their lean inventories with goods largely coming from overseas, despite increases in oil and commodity prices. This has benefited UPS, FedEx and other freight transportation providers such as Expeditors International and Kuehne + Nagel.

#### **Q: YOU MENTIONED THE CONSTRUCTION MARKETS EARLIER. DO THESE STOCKS OFFER A POSSIBLE BUYING OPPORTUNITY?**

**Ken Spruell:** Construction is a cyclical business, and it's critical to examine valuations based on where we are in the market cycle. In the case of residential construction, recent dynamics feel very similar to what the trucking industry experienced last year. The news flow was extremely negative about weak freight demand, lack of industry pricing power and excess inventory. It appeared the trucking segment had reached a bottom, and it actually ended the year with modest improvement. Even this slight demand increase trickled down to the rest of the trucking industry, benefiting firms such as PACCAR, a commercial truck manufacturer.

Similar trends have unfolded in residential construction this year. It seems to be all bad news, with climbing U.S. foreclosures, lingering unemployment and sizable homeowner negative equity, but it appears that the cycle bottom may have been reached since things aren't necessarily getting worse. These stocks, however, currently are not priced for any type of recovery, in our opinion, and even a slight improvement in housing starts could generate a rewarding positive reaction in valuation levels. This could create opportunities with home builders, building material companies and across the entire housing supply chain, both with companies directly tied to housing, such as NVR, a home builder, and Owens Corning, which provides composite

and materials systems, as well as indirect beneficiaries, such as Illinois Tool Works, which has a residential construction business.

In commercial construction, the key indicator we watch is the Architecture Billing Index (ABI)\*. During the past 18 months, the ABI has hovered near bottom ranges, but recently it has become an expansionary indicator, topping over 50 in October. That's a potential signal of nonresidential construction improvement nine to 12 months out that could benefit firms such as Cooper Industries and Johnson Controls, both of which are directly tied to these markets.

#### **Q: WHAT OTHER TYPES OF METRICS DOES JANUS UTILIZE WHEN RESEARCHING INDUSTRIALS?**

**Ken Spruell:** Widely available macro indicators like the ABI are useful in terms of cyclical analysis and historical perspective. We also conduct extensive grassroots research, including proprietary market surveys used to poll our industry contacts, ranging from truck and automobile dealers to shipping companies and agents. These quarterly questionnaires typically cover crucial areas such as industry trends, six- to 12-month outlook expectations, pricing levels and inventory holdings, all of which offer fairly comprehensive insights that may or may not validate macroeconomic signals.

Our research methodology also consists of various checkpoints to help determine investment potential. For example, when we research firms such as PACCAR, we first gauge overall industry health, employing measures such as weekly used truck inventory and pricing. When those markets tighten, new equipment orders typically rise, which benefits PACCAR. We also audit inventory levels and anticipated sales volumes by surveying PACCAR dealers, and this provides a confirming data point on how business is trending for the company.

This process can be extremely granular. Researching the airline industry, for example, goes well beyond a high-level capacity analysis. We've actually had analysts go to the desert in Southern California and Arizona to count idle commercial aircraft parked in the world's largest graveyard facilities to directly measure spare capacity. The goal was to assess which airplanes were worthy of being brought back into service, versus those that would ultimately be sold to emerging market airlines or simply be stripped for spare parts. This detailed level of research helps us build realistic capacity models, based on actual airplane supply and likely demand.

\*The Architecture Billings Index (ABI) is a diffusion index derived from the monthly Work-on-the-Boards survey, conducted by the AIA Economics & Market Research Group. The ABI serves as a leading economic indicator that leads nonresidential construction activity by approximately 9-12 months.

**Q: HOW IMPORTANT IS CHINA'S ROLE IN THE INDUSTRIALS SECTOR?**

**Ken Spruell:** Most industrial companies view China as a short-term opportunity but, ultimately, a long-term threat. There's an increasingly sharp level of distinction between firms that have learned how to compete and be profitable in – and against – China versus those that have not. China's already well up the learning curve in industrial products tied to power generation, rail infrastructure, aerospace industry and automobiles, with significant exports to other emerging markets.

Examples of this trend include recent large power generation orders from India for companies based in China. For instance, Shanghai Electric has won a \$10 billion contract to supply coal turbines for coal power generation in India, and historically this has been owned by Western companies such as Alstom.

Over the next 10 years, most industrial companies probably will face increasing price pressure from Chinese competitors, which have substantial government support and significant manufacturing capacity. This is a very real threat that industrial companies must live with and figure out a way to compete against it. It goes back to what I mentioned earlier in terms of cost advantages being more important than product advantages in the sector.

One way some industrial firms are navigating this challenge is by acquiring Chinese companies or establishing joint ventures. The key is to capture top market position locally and deliver meaningful cost advantages. Firms that have pursued joint ventures have had mixed results because many of these undertakings have ended up only being transfers of technology and intellectual property which have further accelerated the rise of Chinese competitors. The more recent trend has been for firms either to acquire 100% of a local company or maintain proprietary intellectual capital in Western markets, focusing on building assembly operations in China to establish a presence and compete in the region.

**Q: WHAT ABOUT RISING RAW MATERIAL COSTS? HOW HAS THAT AFFECTED THE SECTOR?**

**Ken Spruell:** This is another area where China is a mixed blessing. These markets have increased demand for industrial goods, but they also have been a primary driver of rising commodity prices. Most industrial companies use steel, copper and/or aluminum in their products, and this commodity price inflation is squeezing corporate margins across much of the sector.

There have been both winners and losers in how companies have figured out how to offset these price increases. Firms with durable business models, such as FedEx, UPS and PACCAR, have exhibited pricing power and have been able to pass on this inflation to end clients. Other companies are struggling and trying to play catch up, such as select firms in the construction equipment industry.

**Q: LOOKING AHEAD, WHAT DO YOU THINK WILL BE THE KEY CRITERIA FOR SUCCESSFUL INDUSTRIAL FIRMS?**

**Ken Spruell:** We expect companies with strong business models and compelling price advantages to continue to deliver attractive growth opportunities to investors. In addition, while industrial companies typically have grown at GDP-type rates, these firms also usually have very solid cash flow characteristics. Consequently, smart capital allocation is essential for long-term success, because there's a lot of cash flow that needs to be reinvested.

Capital deployment decisions can boost – or haunt – management teams for years. In the current market environment, smart acquisitions can still make sense as can strategic internal reinvestment, but we also like to see capital returned to shareholders, either in dividends or through share buybacks. A carefully calculated combination of these strategies can deliver immediate shareholder value, while still providing for higher cash flows and returns down the road. Firms with the ability to allocate capital intelligently and with established effective business models should be able to adapt and thrive in the years ahead.

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**See last page for important disclosures.**

## ABOUT THE FEATURED ANALYST

### Kenneth Spruell, CFA

Ken Spruell is an equity research analyst, primarily focusing on the industrial sector. Prior to joining Janus as a research analyst in June 2008, Mr. Spruell served as a principal at Fayez Sarofim & Company where he held both portfolio management and research analyst roles focusing on the industrial and healthcare sectors. Prior to that, he served as a student portfolio manager and analyst for the MBA Investment Fund at the University of Texas. Mr. Spruell also served as a digital design engineer at National Semiconductor Corporation. He received his bachelor of science degree in electrical engineering from Rice University and his MBA, with a concentration in finance and entrepreneurship, from the University of Texas, McCombs School of Business. Mr. Spruell holds the Chartered Financial Analyst designation and has 9 years of financial industry experience.

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151 Detroit Street, Denver, CO 80206 | 800.227.0486 | [www.janus.com](http://www.janus.com)

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