TRINITY SMF

STUDENT MANAGED FUND

Industrials Sector Report

2023-2024

Sector Managers

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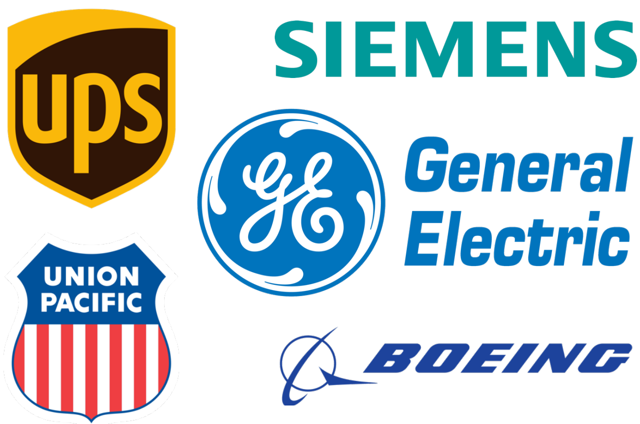
Sector Overview

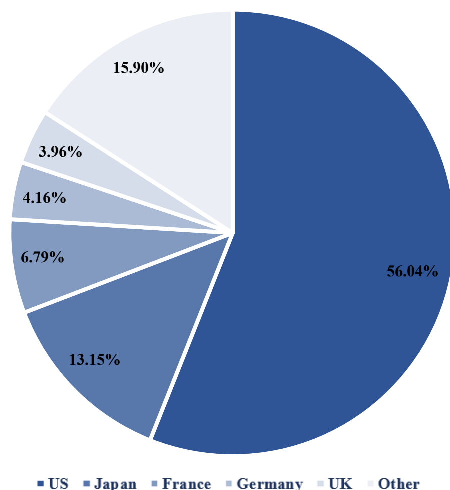
The industrials sector is the lifeblood of the economy and covers a broad range of companies that primarily engage in three main business activities: manufacturing and distribution of capital goods, provision of commercial services and products, and supply of transportation services. As of July 2023, the industrials sector has a market value of $6.43 trillion, representing around 11% of the overall market and ranking as the 5th largest global sector.

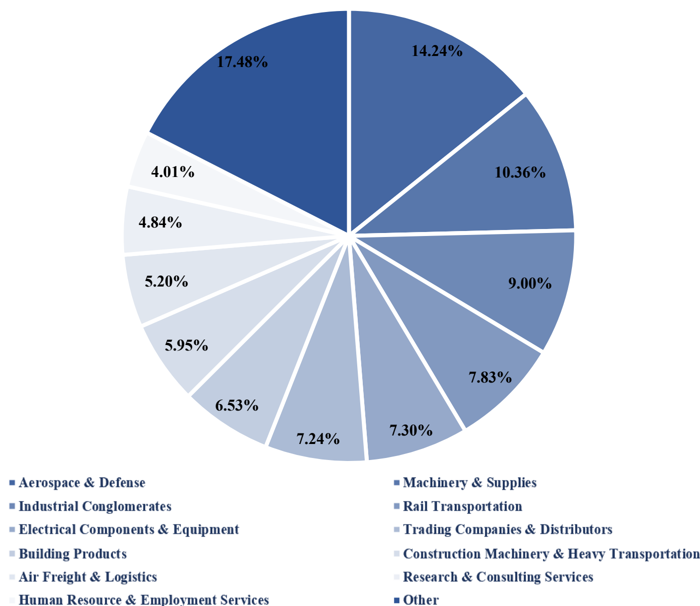
The prevailing theme within the sector is sensitivity to economic growth – the sector tends to outperform in rising markets and underperform in falling markets. Given the current economic backdrop, a prolonged period of economic downturn could potentially have adverse effects on sector performance.

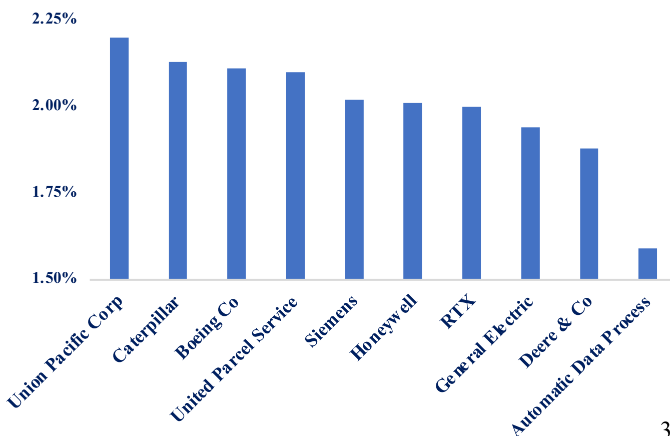
Nonetheless, despite the sector's cyclical nature, there exist several "megatrends" that are propelling advancements and presenting substantial opportunities for growth. These trends are set to drive expansion irrespective of the fundamental shifts within the industries they serve.



P/E Fwd	18.49
Dividend Yield	1.92%
P/BV	3.51
Net Return YTD	17.6%







Key Players & Performance Indicators

The industrials sector comprises three primary segments: Capital Goods, Transportation, and Commercial Services. While factors such as GDP, PMI and interest rates impact the entire sector, each subsector is subject to unique KPIs and business cycle stages.

Capital Goods – 66% of Industrials Sector

Aerospace & Defense:
Manufacturers of civil or military aerospace and defense equipment, parts or products
Key Players: Raytheon Technologies (NYSE: RTX) & Airbus SE (ENXTPA: AIR)
KPI's: Geopolitical uncertainty & defense spending

Farm & Heavy Construction Machinery:
Manufacture machinery and provide various services for agriculture, construction, and miscellaneous earth-mover use cases
Key Players: Caterpillar (NYSE: CAT) & Deere & Co (NYSE: DE)
KPI's: GDP, interest rates, weather & PMI

Industrial Conglomerates:
Diversified industrial companies with business activities spanning across three or more subsectors
Key Players: Honeywell (NYSE: HON) & Siemens (XTRA: SIE)
KPI's: Volatility, oil prices & government spending

Engineering & Construction:
Non-residential construction and maintenance of engineering products such as roads, tunnels and skyscrapers
Key Players: Vinci SA (ENXTPA: DG) & Johnson Controls International (NYSE: JCI)
KPI's: Government spending & interest rates

Transportation – 19% of Industrials Sector

Automobile Manufacturers:
Companies that mainly produce passenger automobiles and light trucks
Key Players: General Motors Co (NYSE: GM) & Ford Motor Co (NYSE: F)
KPI's: Energy prices, consumer demand & GDP

Airlines:
Providers of passenger air transportation, primarily via airplane
Key Players: SouthWest (NYSE: LUV) & Delta (NYSE: DAL)
KPI's: Oil prices & revenue passenger miles

Integrated Freight & Logistics:
Companies that transfer goods between sellers and purchasers across air, road, maritime and rail travel
Key Players: United Parcel Service (NYSE: UPS) & FedEx (NYSE: FDX)
KPI's: PMI, inflation, consumer demand & GDP

Trading Companies & Distributors:
Companies which operate in the wholesale and distribution of a wide range of goods and services
Key Players: The Home Depot (NYSE: HD) & Lowe's Companies (NYSE: LOW)
KPI's: Consumer demand & inflation rates

Commercial Services – 15% of Industrials Sector

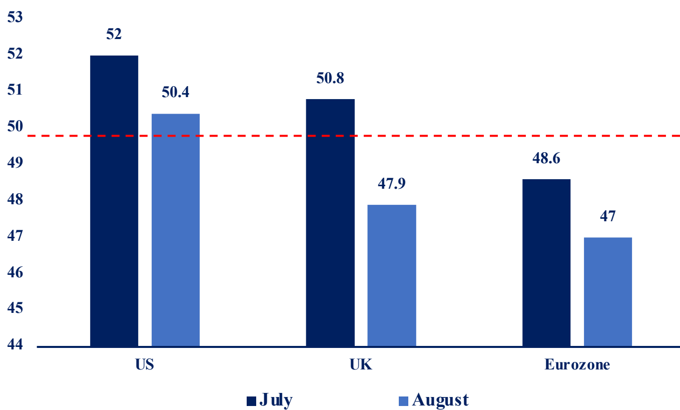
Staffing & Employment Services:
Providers of business support services relating to human capital management, including employee training, payroll processing and retirement support
Key Players: Automatic Data Processing (NYSE: ADP) & and Paychex (NYSE: PAYX)
KPI's: PMI & GDP

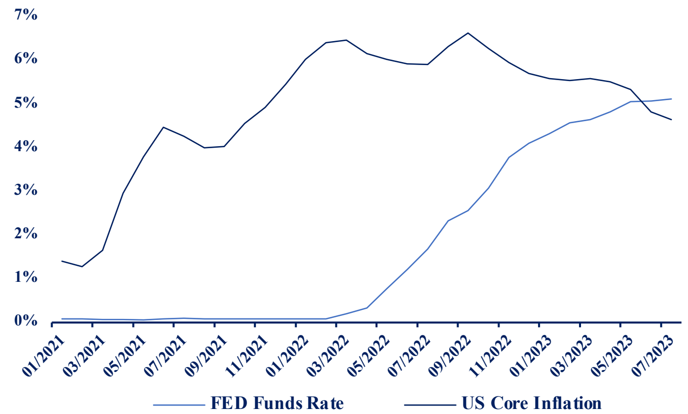
Commercial Services & Supplies:
Providers of commercial printing, environmental and facilities services, diversified support service and security services
Key Players: Waste Management (NYSE: WM) and Republic Services (NYSE: RSG)
KPI's: PMI & GDP

Current Climate

Following a decade of relative stability, the global economy has been presented with a series of unprecedented challenges in recent years. The pandemic, war in Ukraine, rising interest rates, banking crisis and recession threat have collectively given rise to an unparalleled degree of global uncertainty and market volatility. Persistent inflationary pressure and supply constraints pushed central banks to systematically hold policy tight. In the past year and a half, the US Federal Reserve has raised interest rates to 5.5% - the highest level in 22 years, in the fight to stabilise prices in the world's largest economy. The current investment landscape is a stark departure from the low-interest rate environment that prevailed prior to the pandemic, bringing forth fresh hurdles, as well as new possibilities.

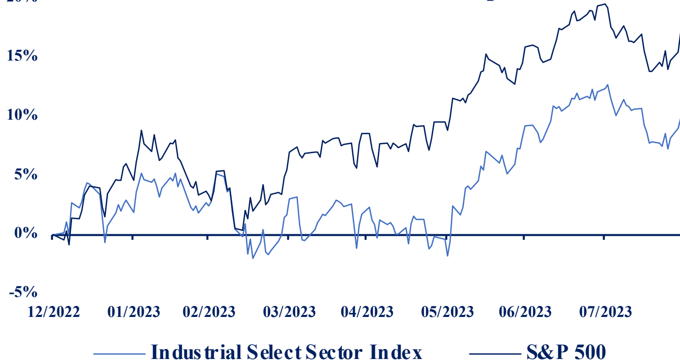
Amid market challenges, growth has shown unexpected resilience with positive indicators emerging. In Q2 2023, increased consumer spending and business investments led to higher-than-expected real GDP growth of 2.4% annualised. However, the elusive target of a "soft landing" remains uncertain. As credit tightens further and job gains slow, extrapolating recent growth and strong demand would be premature. Although core inflation in the US has dropped to 4.8%, it remains double the targeted 2%. The preliminary August PMI Manufacturing and Services figures show notable momentum loss in US and European business activity, serving as a reminder that full lagged effects of tightening on the economy are yet to be seen. Looking ahead, investors must adopt a stance of ***cautious optimism***.

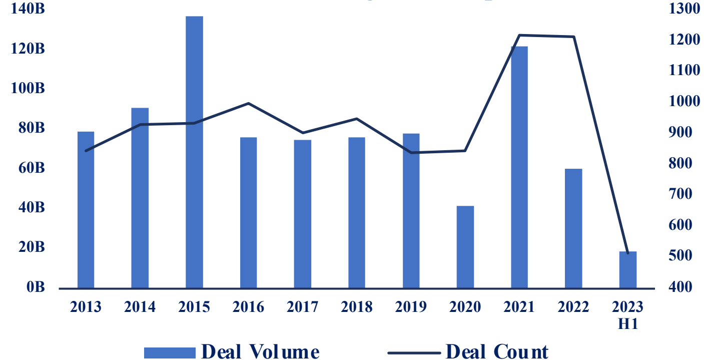




Thus far in 2023, the industrial sector lags the S&P 500 by 693bps. Moving forward, a ***cautious*** approach must be maintained when identifying sector opportunities. Recession fears, low business confidence and interest rate hikes have led to a slowdown in manufacturing output, with the global manufacturing PMI moving into contraction territory. Industrial M&A activity has been weak YTD, as companies adopt a more conservative approach due to the uncertain macroeconomic outlook. Nonetheless, it is important to remember that the industrials sector covers a diverse range of business activities, each yielding distinct returns and operating on different business cycles.

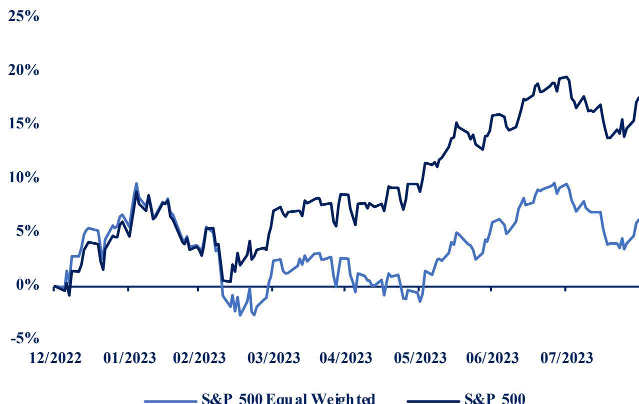
As the global economy navigates a "soft landing," and further opportunities emerge from moderating inflation and improved supply chains, increased ***optimism*** can be leveraged in the industrials sector by identifying thematic areas aligning with emerging opportunities.





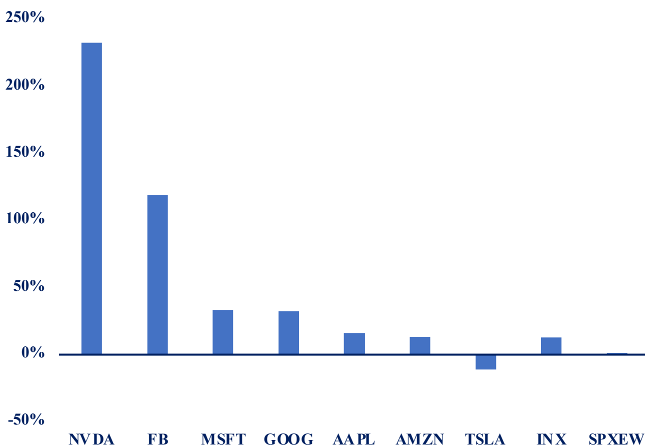
Investing Themes

S&P 500 vs S&P 500 Equal Weighted Returns YTD



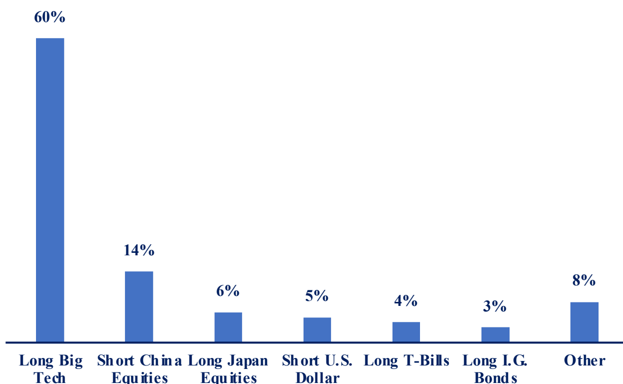
Equity performance year-to-date has been characterised by market narrowness. The market-capitalisation weighted S&P 500 is outperforming its equal weighted counterpart by nearly 10% YTD. This trend is primarily driven by the dominance of the "magnificent seven" US tech giants - Apple, Amazon, Alphabet, Microsoft, Meta, Nvidia, and Tesla. These companies have collectively delivered returns of over 50% YTD, overshadowing the single-digit returns of the remaining 493 stocks in the index. The demand for this concentrated group of stocks can be attributed to the euphoria surrounding artificial intelligence, alongside the return in favour of big tech companies. This resurgence is supported by the US economy's resilience, positive earnings and hopes of an imminent end to the rate-hiking cycle.

Share Performance YTD



Although the artificial intelligence mania offered good reason to seek out the largest cash-rich, tech-driven names, the current market concentration is excessively narrow, top-heavy, and unsustainable. Looking ahead, market leadership is poised to broaden. As of August 2023, more than 70% of S&P 500 stocks are trading above their 200-day moving average, a significant increase from just over 40% at the end of May. Additionally, equal-weighted exchange-traded funds have attracted record investments in recent months, indicating an improving U.S. economy and growing market breadth. As caution grows regarding the towering valuations of mega caps, and as investors seek to diversify beyond big tech, opportunities are emerging in traditional economy-linked sectors, such as industrials.

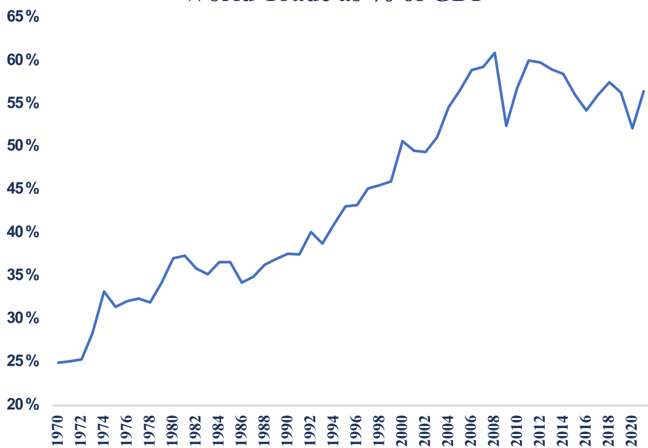
BofA Fund Manager Survey - Most Overcrowded Trade in the Market

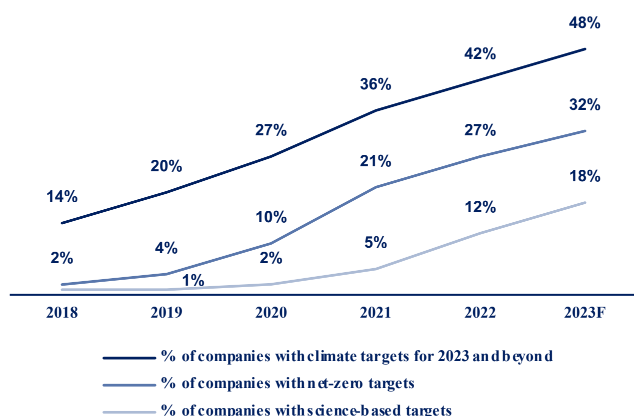


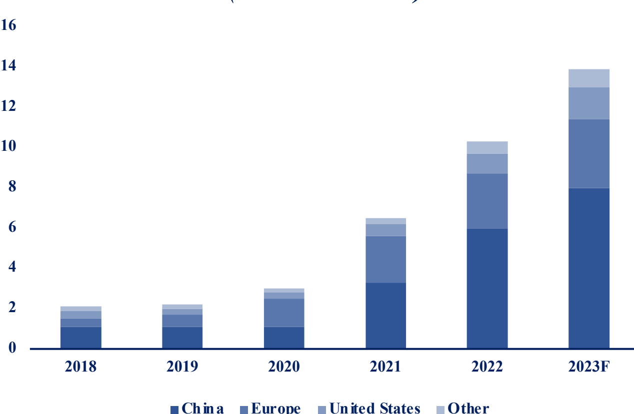
These opportunities lie within the realm of quality companies, characterised by optimal leverage, earnings recurrence and protected dividends. Poor earnings quality has been widespread over the past two quarters, as many companies are recording high levels of accruals and low levels of operating cash. Creative accounting is being used to disguise the macro damage that businesses have endured in recent months. Recent market volatility has meant there are an abundance of relative value opportunities due to potential market mispricings. However, meticulous examination of financial statements needs to be undertaken to ensure quality of earnings.

While quality remains the key focus, there exists great potential in leveraging the megatrends that are fundamentally reshaping the industrial landscape. Powerful forces such as the **rewiring of global supply chains** and the **low-carbon transition** are disrupting the entire sector. Determining areas where these trends are not yet priced in presents significant growth opportunity.

Investing Themes







Supply Chain Rewiring:

After decades of globalisation and geopolitical moderation, where efficiency and cost savings were prioritised, the industrials sector is shifting focus toward national security and supply chain resilience. The pandemic exposed vulnerabilities tied to single-source reliance, leading to industry-wide shortages. Geopolitical tensions, like US-China disputes and the Russia-Ukraine conflict, underscored the risks of depending heavily on one region, especially for critical supplies like natural gas.

Consequently, there is a growing emphasis on rewiring supply chains, often by relocating operations closer to allied nations. Companies are notably shifting away from China, favoring Southeast Asia, Mexico, India, and the US. The Biden administration has also taken significant steps to boost domestic manufacturing and reduce supply chain vulnerabilities. Key legislative initiatives, such as the Inflation Reduction Act and the Chips and Science Act, are aimed at strengthening the US' manufacturing capabilities.

The shift offers opportunities for businesses in the industrials sector to adapt and strengthen their supply chains amid a changing geopolitical landscape. Successfully rewiring supply chains for increased security and resilience will position companies for long-term success.

Low-Carbon Transition:

The growing focus on decarbonisation and net-zero emissions is reshaping industries worldwide. Approximately 48% of listed companies now have decarbonisation goals, with 32% committed to achieving net-zero emissions by 2050. Global regulatory initiatives, such as the US Inflation Reduction Act and the European Climate Law, are providing clear sustainability guidelines. The transition to a low-carbon future, once a matter of "if," is now a question of "when".

The industrials sector, in particular, is uniquely poised to benefit from this shift. The reallocation of capital within energy systems, driven by the transition to low-carbon alternatives, presents opportunities for industrials to provide critical infrastructure and services. This includes upgrading and expanding power grids, developing energy storage solutions, and enhancing energy efficiency in various industries. Additionally, manufacturers involved in EV production, including battery manufacturers, are experiencing unprecedented growth. The industrials sector is therefore strategically positioned to thrive in the low-carbon transition era.

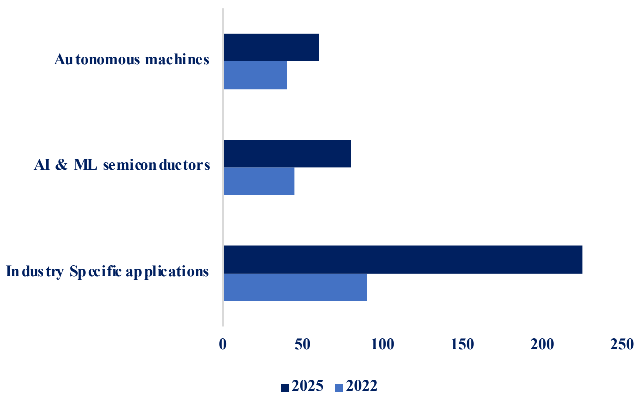
Overlooked Sector Drivers

Digitisation and Artificial Intelligence:

Digitisation and artificial intelligence are emerging as powerful, yet often underestimated, drivers of growth within the industrials sector. The COVID-19 pandemic exposed vulnerabilities in global supply chains, prompting a rapid acceleration of digitisation efforts, particularly in logistics, which previously relied on paper-based processes..

As supply chains recover post-pandemic, the full impact of these integrated technologies is yet to be realised. Improving macroeconomic conditions will provide companies with an opportunity to leverage these new technologies, enhancing operating margins.

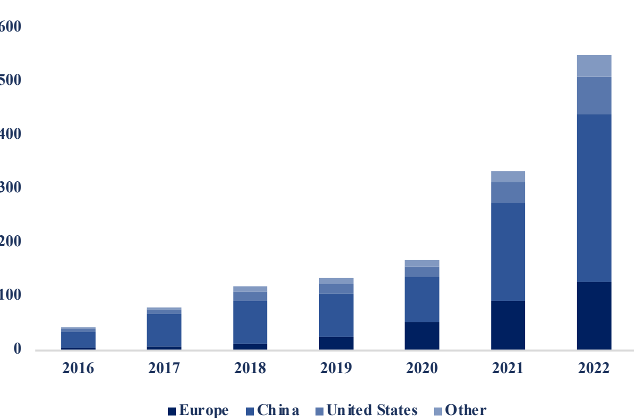
Additionally, AI, with expected spending exceeding $400 billion by 2025, made significant advancements in late 2022 and early 2023, particularly in machine learning. While the technological sector has already priced in AI adoption, its potential impact on the industrials sector is often overlooked. AI influences infrastructure planning, human resources, supply chains, logistics, and specialised industries, offering improved labour productivity and expanded profit margins. Moreover, it can drive the growth of autonomous machines, further advancing the industry's capabilities.



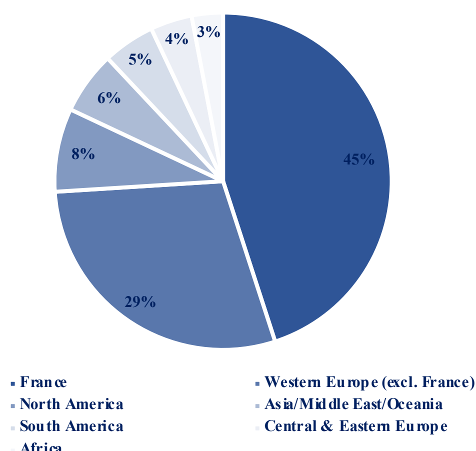
Improvements in Battery Technology:

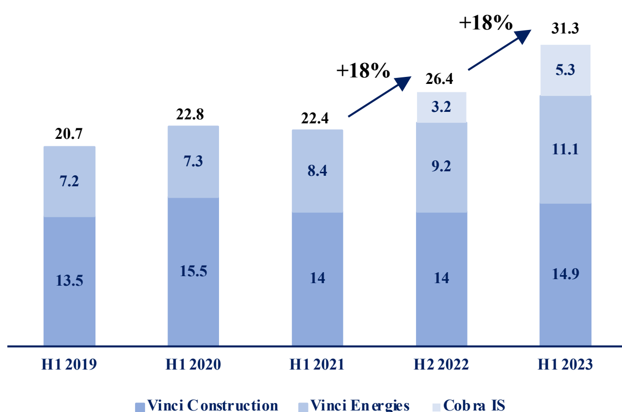
Improved battery technology, particularly the evolution of lithium-ion batteries since Sony's pioneering introduction in 1991, has been a pivotal but often overlooked driver for industrial growth.

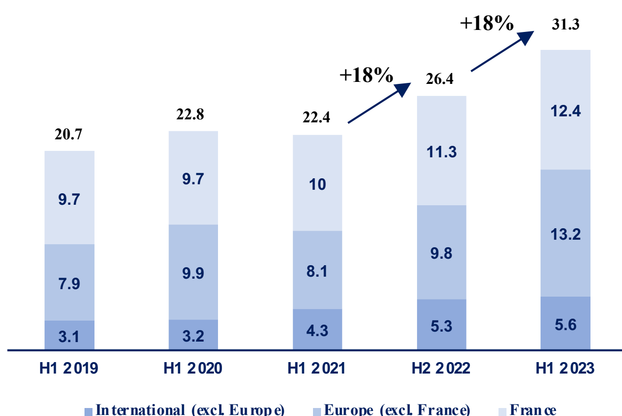
Continuous research and innovation have significantly enhanced energy density, lifespan, and safety while substantially reducing costs. Advancements in electrode materials, electrolytes, and manufacturing processes have resulted in lighter, more compact batteries with greater energy storage capacity. These improvements have not only transformed consumer electronics but have also facilitated the widespread adoption of electric vehicles and renewable energy storage. Industrial companies stand to benefit significantly from these advancements, particularly in the context of the expanding electric vehicle market, which presents a lucrative growth opportunity.



Current Holdings – Vinci SA (Hold)







Vinci SA (ENXTPA: DG) is a diversified French-based industrial company engaged in concessions, energy, and construction businesses worldwide, with a workforce of over 272,000 people. Vinci's operations span across France and international markets, accounting for 44% and 56% of its revenue, respectively.

The Concessions segment designs, finances, and operates transport infrastructure and public facilities under public-private partnerships. The Energy segment serves manufacturing, infrastructure, and renewable energy projects, also offering services in facilities management and information technology. The Construction segment specialises in various projects, including general contracting, engineering work, digital activities, and nuclear engineering services, often collaborating with local companies on building, roads, rails, and water projects.

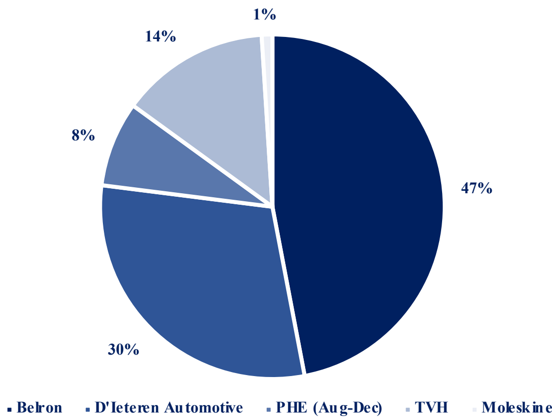
Vinci SA's financial strength and operational excellence are evident in its robust performance. The company has demonstrated remarkable growth across its diverse business segments. In H1 2023, consolidated revenue reached €32.4 billion, marking a notable 13% increase from the previous year. Moreover, Vinci has consistently generated strong free cash flow, with a 10-year FCF CAGR of +11.7%.

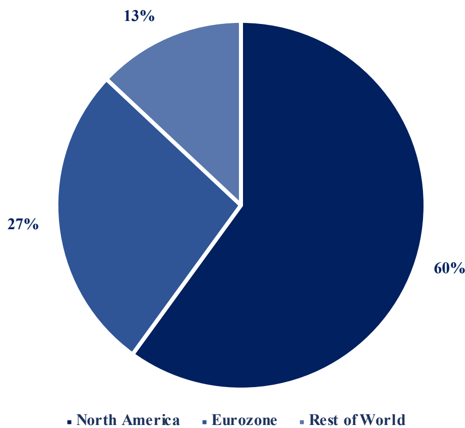
The company's financial strength is further highlighted by its prudent approach to financial management, reflected in its healthy net cash position of €8.0 billion in Q2 2023 and access to substantial credit facilities. This financial stability enhances Vinci's capacity for strategic investments and sustainable growth.

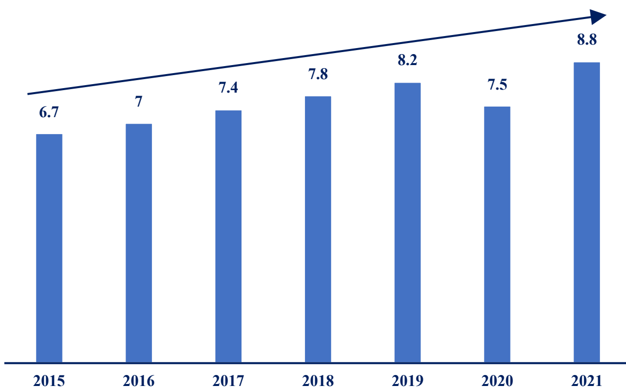
Through a highly decentralized structure, the company remains agile and adaptable to unpredictability in the environment. Driven by an aggressive M&A strategy and a focus on expanding into new geographies, Vinci consistently secures large-scale contracts through competitive bidding processes.

Why DG? Vinci Energies is strategically positioned to benefit from the renewable energy megatrend and is poised for significant business growth. Notably, the newly acquired subsidiary, Cobra IS, anticipates revenue growth of over 10%, supported by a strong order book and sizable EPC projects. Vinci is capitalising on Cobra IS's specialised activities to develop an electricity production asset portfolio, which has been identified as a promising long-term growth asset. Moreover, further recovery in air passenger traffic to pre-pandemic levels should allow for an improvement in operating earnings for Vinci Airports.

Case Study







D'Ieteren Group (ENXTBR: DIE) is a family-controlled investment firm with a market capitalisation of €8.5 billion. The company operates four core businesses: Belron, D'Ieteren Automotive, TVH, and PHE, collectively offering a wide range of automotive services, including brand vehicle distribution, used vehicle sales, maintenance, financing, and spare parts distribution.

Belron, a global leader in vehicle glass repair, replacement, and recalibration (VGRRR), is the primary revenue driver, contributing over 50% to the firm's profits. This subsidiary serves customers across 37 countries, with a significant portion of its business originating from insurance companies, as Belron manages vehicle glass and insurance claims on their behalf.

Another subsidiary, D'Ieteren Automotive, also contributes significantly to the firm's revenue. As the leading car distributor in Belgium with a 22.5% market share, it holds the exclusive distribution rights to brands such as VW, Audi, and Porsche. D'Ieteren Automotive also has a strong presence in the EV market, with a 26% market share in Belgium, and an extensive network of charging stations.

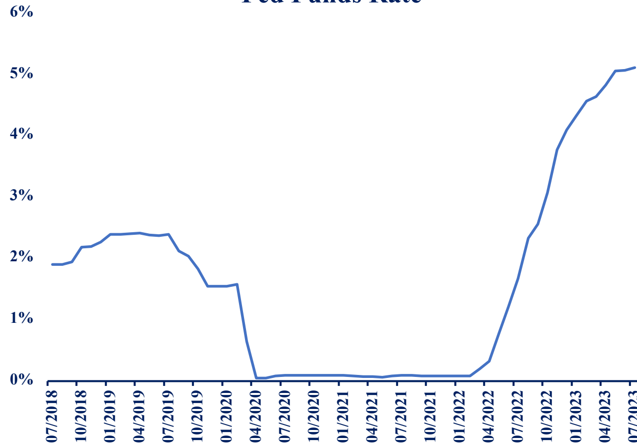
D'Ieteren Group's legacy is deeply rooted in over two centuries of dedicated leadership. The company's ability to swiftly adapt by acquiring and divesting businesses has allowed it to capitalise on emerging markets consistently, a key factor contributing to its enduring success.

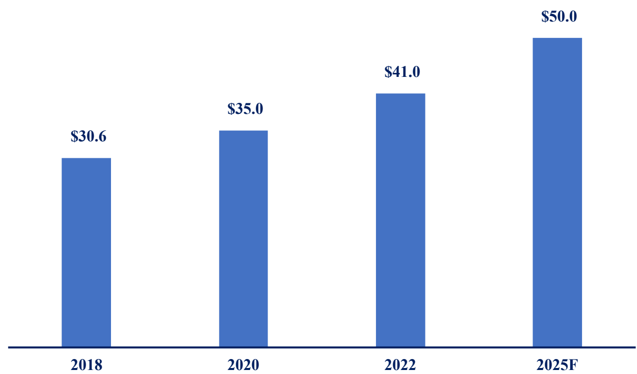
Why DIE? D'Ieteren Group is strategically positioned to benefit from the changing automotive industry. Trends like digitisation and electrification offer significant growth opportunities, as the global electric vehicle market is expected to grow at an 18.2% CAGR from 2021 to 2030. D'Ieteren Group already holds leading positions in various markets related to these trends, many of which are fragmented, presenting consolidation opportunities. The firm's proven M&A track record further supports the growth potential.

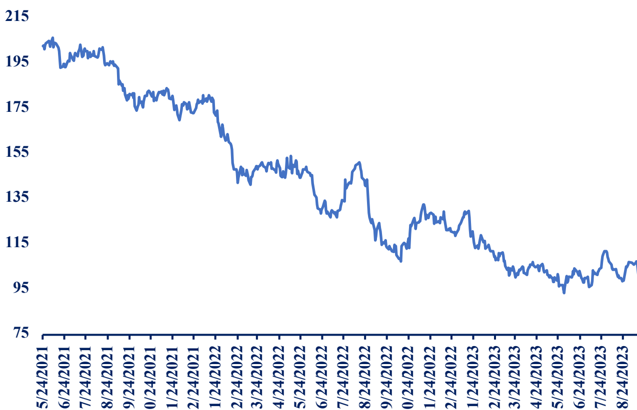
EU and US regulations align with D'Ieteren's focus on innovation and safety, mandating ADAS standards for new vehicle models. Additionally, evolving vehicle glass trends, such as increased size, shape complexity, and energy-efficient thinning, create barriers to entry, favoring Belron, its primary revenue source.

D'Ieteren Group's diverse portfolio, adaptability, and market positioning will allow the firm to thrive in the rapidly evolving automotive landscape.

Risks







Business Cycle Risk:

The industrials sector is "cyclical" – it tends to underperform in bearish markets and outperform in bullish markets. Presently, central banks worldwide have aggressively raised interest rates to combat inflation. Consequently, increased borrowing costs have reduced the aggregate capital invested and already caused a noticeable deceleration in manufacturing activity.

While the economy seems to be navigating a "soft landing" as of now, a prolonged global economic downturn could worsen the contraction within the industrials sector. This cyclicality poses a significant investment risk in the sector. However, given the wide-range of business activities within industrials, the risk can be mitigated by identifying counter-cyclical subsectors.

Environmental, Social and Governance Considerations:

Although "ESG" investing has fallen out of favour in recent months, as the term has become increasingly polarised and politicised, assessing environmental, social and governance risks when analysing a company remains vital. Long-term business sustainability relies on factors beyond financial returns, and ESG considerations must acknowledged.

Compliance with environmental regulations is of utmost importance for industrials companies. The pursuit of a sustainable future has been a global priority for many years, and companies must align with this demand.

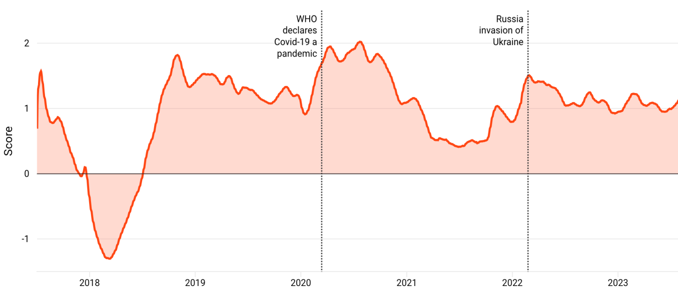
Beyond environmental considerations, ESG risks in the industrials sector also concern labour issues and product safety and quality. Amid ongoing market uncertainty, investors must keep in mind that economic downturns often trigger cost-cutting measures, including layoffs. However, excessive cost-cutting can have adverse effects on employee morale and talent attraction, hurting business performance.

Additionally, while larger firms may financially weather product liabilities, reputational damage from high-profile lawsuits can be catastrophic. For instance, 3M's recent legal challenges, including a $6 billion settlement over defective earplugs, have significantly impacted its share price, which has fallen over 50% in the past three years. Although most companies actively mitigate these risks and have sales to government agencies which require thorough protocols, vigilance is needed when examining business procedures.

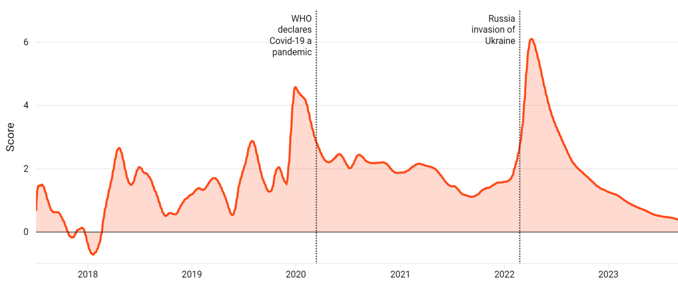
Despite the current anti-ESG sentiment, environmental, social, and governance considerations continue to be financially relevant and integral to the investment process.

Risks

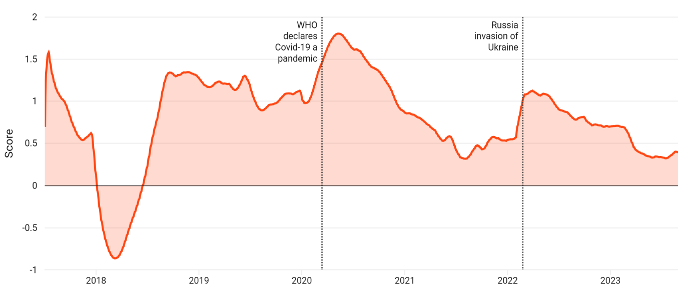
BlackRock Geopolitical Risk Indicator: US-China Strategic Competition Risk



BlackRock Geopolitical Risk Indicator: Russia-NATO Conflict



BlackRock Geopolitical Risk Indicator: Emerging Markets Political Crisis



Geopolitical Tensions:

The industrials sector, with its intricate global footprint, is highly susceptible to geopolitical disruptions. Companies in this sector have long-term investments in various countries and rely on sprawling supply chains. Even companies not directly affected by geopolitical tensions still face significant risks because they participate in the same interconnected value chains, serving as suppliers or ecosystem partners.

According to the global BlackRock Geopolitical Risk Indicator (BGRI), geopolitical risks that primarily affect the industrials sector remain a significant concern. For instance, US-China relations, which are critical to global manufacturing, are rated as a high-level risk.

The US imports more from China than any other country, and China is a top export market for US goods and services. Despite increased government spending, domestic manufacturing revival remains slow in the US, making complete disengagement from China challenging. There are high risks of accidental or intentional conflict escalation, especially concerning Taiwan. Therefore, when making investment decisions, a company's presence in these regions requires careful consideration.

The Russian invasion of Ukraine has also significantly impacted industrial companies. This issue remains ongoing, as no diplomatic solution appears likely in the short run. According to the Financial Times, Europe's largest businesses have lost €100 billion in profits by reducing or scaling back their operations in Russia, and further losses are set to be incurred, particularly by the industrials sector, as more business operations are moved out of Russia.

Lastly, the emerging electric vehicle market relies heavily on lithium, and African countries holds approximately 30% of global mineral reserves. However, there are numerous challenges associated with extracting lithium from these countries, such as corruption and military coups, that prevent the flow of these vital resources to manufacturing facilities. When exploring EV market opportunities, these supply chain disruptions need to be kept in mind.

Given the uncertain global landscape, companies must enhance resilience and defensive strategies. Acknowledging exposure to key geopolitical tensions is essential in shaping investment strategies.