Trinity Student Managed Fund
Sector Reports

Industrials

September 2024

TRINITY SMF
STUDENT MANAGED FUND

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Sector Overview

Industrials: Welcome

The Industrials Sector is concerned with the manufacture and sale of capital goods, the provision of commercial services and the supply of transportation.

Capital goods are physical assets used by businesses to produce goods and services. A tractor is a capital good. Commercial services are services used to generate revenue. Providing tractor software is a commercial service. Transportation services involve the physical transport goods. Delivering a tractor to its end user is a transportation service.

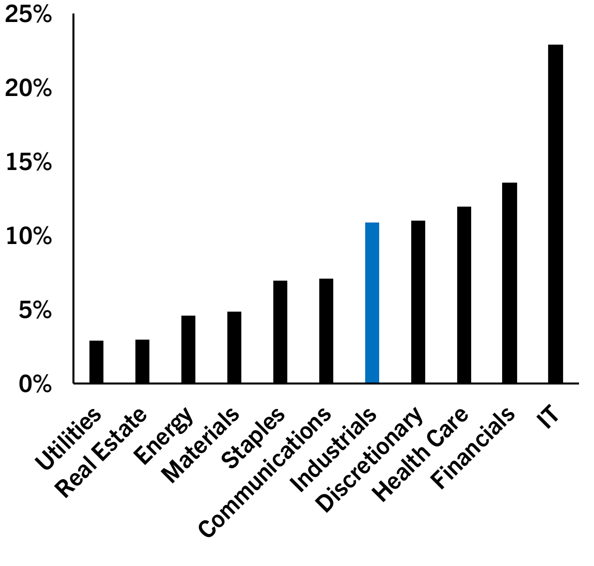
Some companies operate in all parts of the value chain – others focus on just one. Thus, the Industrials sector contains companies like John Deere (NYSE: DE) which produces, maintains and distributes farm equipment as well as companies like Automatic Data Processing (NASDAQ: ADP) which provides HR and Payroll software.

This is naturally an odd alliance, of manufacturing giants and professional service firms, of tractors and software. They are united however in function; of delivering the goods and services that power the world's economy. It makes for a complicated, diverse and ultimately fascinating area to invest in.

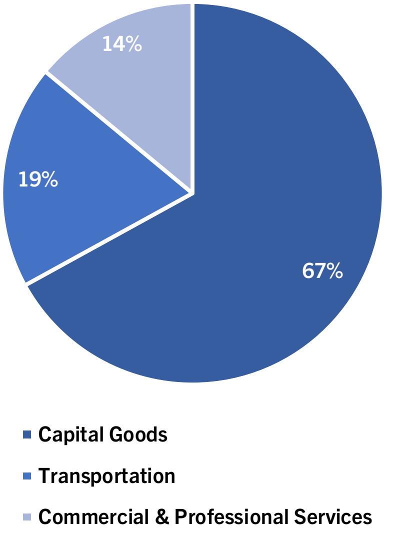
Industrials: Composition

The Industrials sector is diverse, both geographically and in the end markets that it serves. At present, the sector has a market capitalization of $7.3 trillion, or roughly 10% of the global economy. The most important industrial segment is Capital Goods, followed by Transportation, and then finally by Commercial & Professional services.

Sector Weights MSCI World[1]



Segment Weights S&P Industrials[2]



Sector Overview

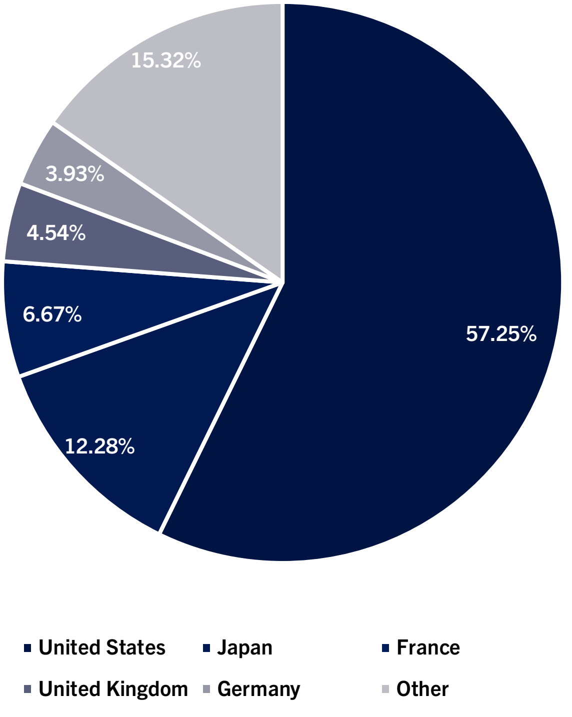
The dominance of Capital Goods within the Industrials sector is due to a few key capital goods sub-industries, such as Aerospace & Defense and Industrial Machinery, which together make up more than a quarter of the entire sector.

Therefore, when thinking about Industrials as a sector, we are primarily thinking about the health of global capital goods manufacturing – and particularly the health the American market, which makes up more than half of the Industrials sector.

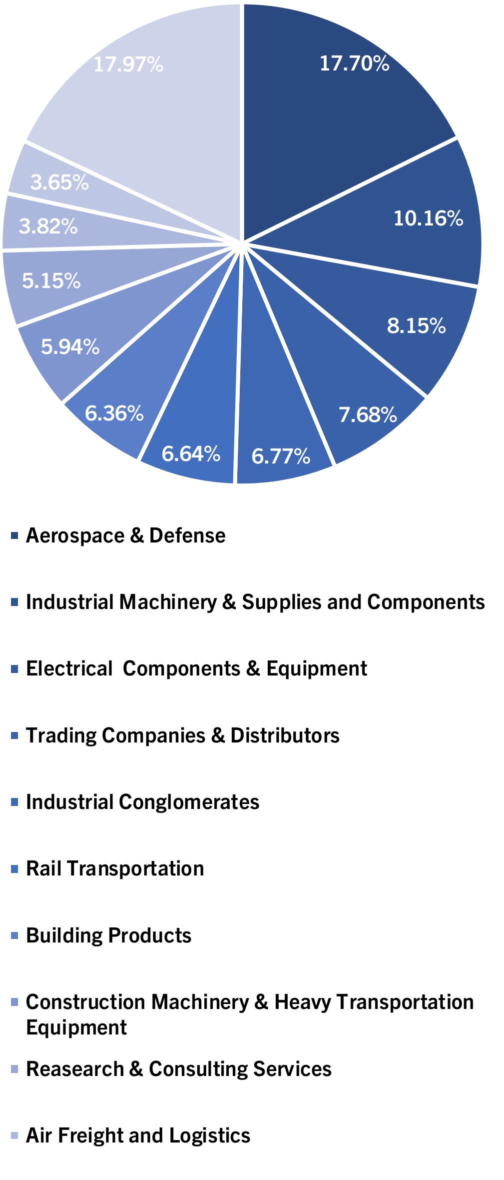
Industrials: Geography

The Industrials sector is highly concentrated within three key markets, the US, Japan & France. However, this underestimates the importance of the US market for the Industrials sector – since within Industrials, globalized multinationals with significant US exposure are the norm.

Country Weights MSCI World Industrials[3]



Sub-Industry Weights MSCI Industrials[4]



KPIs

Industrials: KPIs & PMI

Key Performance Indicators (KPIs) are metrics we use to assess the current state of a business, sector or economy. For instance, a major KPI of the US Economy is Quarterly GDP growth. In Industrials we have two key KPIs; the Manufacturing PMI & Services PMI. As of August 2024, the Manufacturing PMI is contractionary at 47.2 and the Services PMI expansionary at 51.5.[5]

The PMI (Purchasing Managers' Index) is important. It is a reliable reflection of corporate confidence in the economy and closely correlates to future industrial earnings. We can therefore use it in two ways.

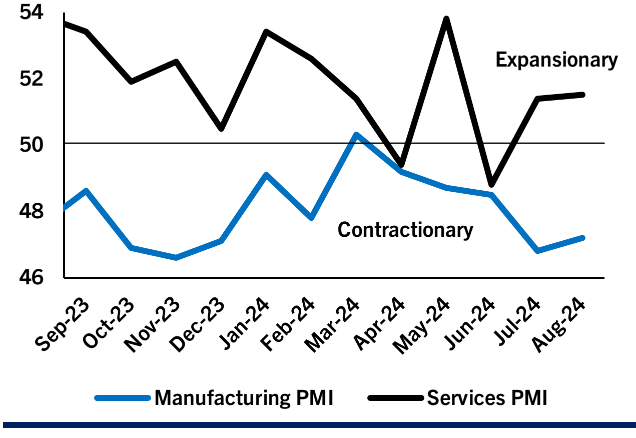
First, the PMI provides a good snapshot of the current state of the Sector. It is more helpful than broader metrics like GDP growth because it directly reflects industrial activity and business conditions. Second it can inform investment decisions, where an expansionary PMI can be a potential tailwind to an investment thesis. The opposite is also true, a contractionary PMI needs to be included as a potential headwind.

Industrials: Business Cycle

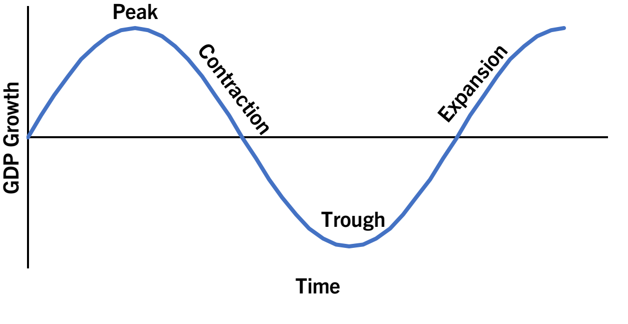
The business cycle is the idea that when economic growth is strong, companies increase their orders for products and equipment. This leads to producers investing into productive capacity, increasing supply and driving down prices. This eventually reduces profits, leading to a contraction. Eventually the market corrects, prices rise, and the cycle repeats itself.

The Industrials sector is highly exposed to this economic cycle, since industrial companies often produce the very equipment and products that drive the cycle. Sectors that are exposed to the cycle are called cyclical sectors. Therefore, an investment decision into an Industrials stock is partly a question of where a company is within its cycle. This requires looking into a company's orderbook and product inventory. These can be derived from an annual report.

Rolling Monthly PMI[6]



The Business Cycle[7]



Subsectors

All Industrial subsectors are reflected in the PMI. However, there are other KPIs worth mentioning that are specific to each sub-sector. What follows is not an exhaustive list, but these are metrics that can be considered when building a thesis in any sub-sector.

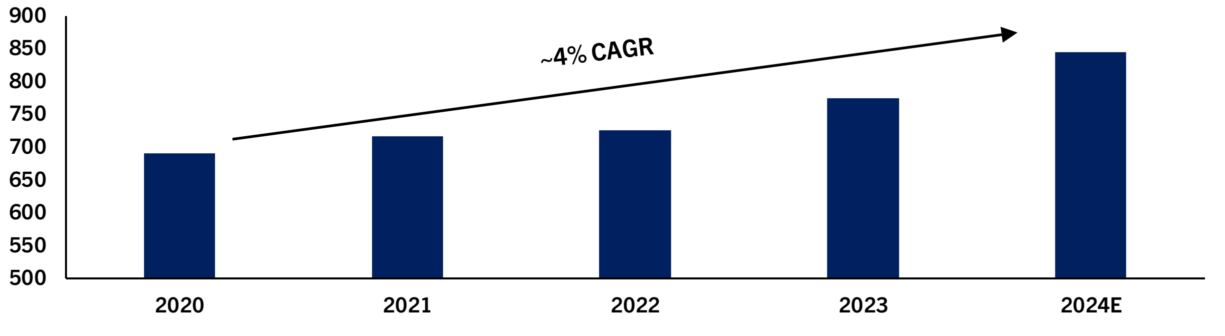
Capital Goods: KPIs

Aerospace & Defense - Manufacturers of civil or military aerospace equipment, parts, and products.

Key Players - Raytheon Technologies (NYSE: RTX) & Airbus SE (ENXTPA: AIR)

KPIs - BlackRock Geopolitical Risk Indicator & US Defense Spending

US Defense Outlays USD B[8]

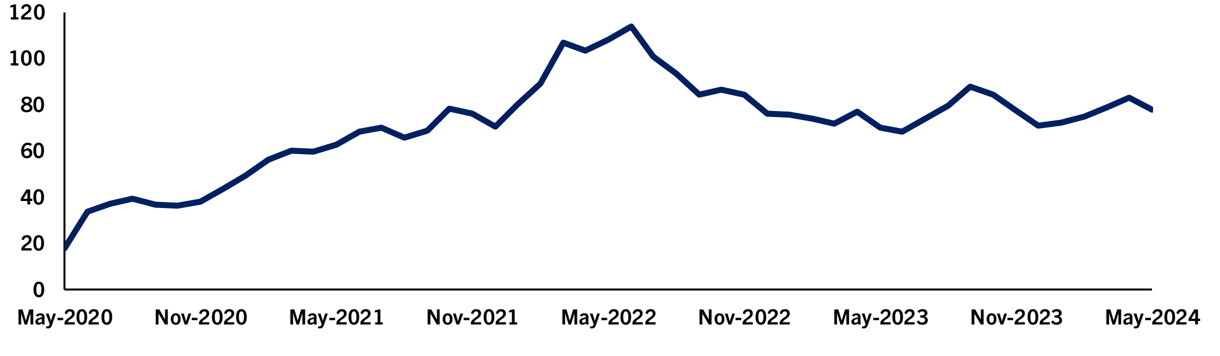


Industrial Conglomerates - Diversified industrial companies with business activities spanning across three or more subsectors.

Key Players - Honeywell (NYSE: HON) & Siemens (XTRA: SIE)

KPIs - Oil prices, Government spending & Industrial M&A Activity

WTI Brent Crude USD/BBL[9]



Subsectors

Farm & Heavy Construction Machinery - Manufacturers of machinery that provide services for agriculture, construction, & mining.

Key Players - Caterpillar (NYSE: CAT) & Deere & Co (NYSE: DE)

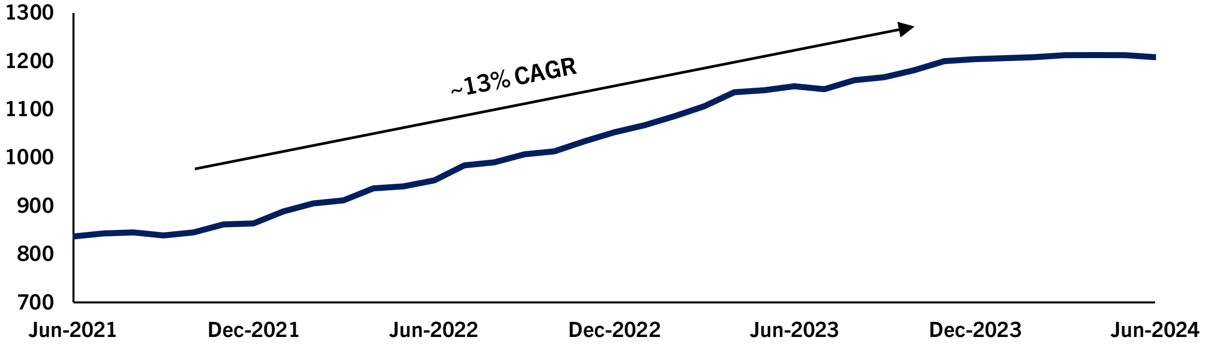
KPIs - Interest rates, Weather, Oil Prices & Commodity Prices

Engineering & Construction - Non-residential construction & maintenance of engineering products like roads, tunnels and skyscrapers.

Key Players - Vinci SA (ENXTPA: DG) & Johnson Controls (NYSE: JCI)

KPIs - Government spending, Interest rates & Construction Spending

Non-Residential Construction Spending USD B[10]



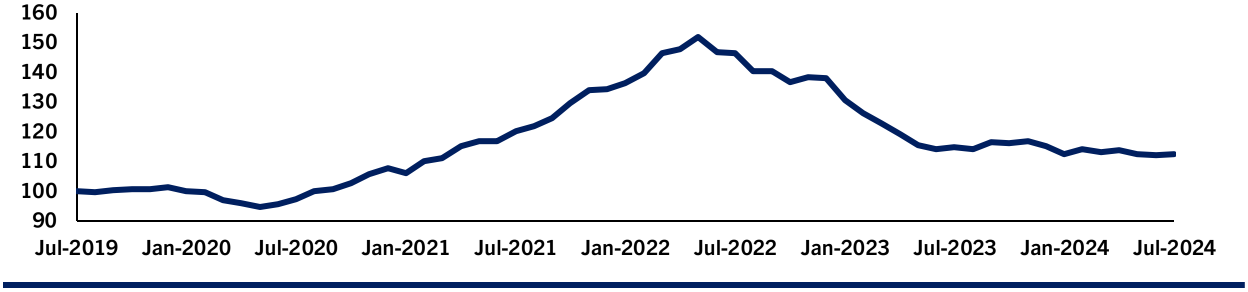
Transportation: KPIs

Freight & Logistics - Companies that transfer goods between sellers and purchasers across land, air & sea.

Key Players - United Parcel Service (NYSE: UPS) & FedEx (NYSE: FDX)

KPIs - Inflation, Consumer demand, Shipping Costs & Geopolitical Uncertainty

US General Freight: Long-Distance Truckload (Rebased to Jul-19)[11]



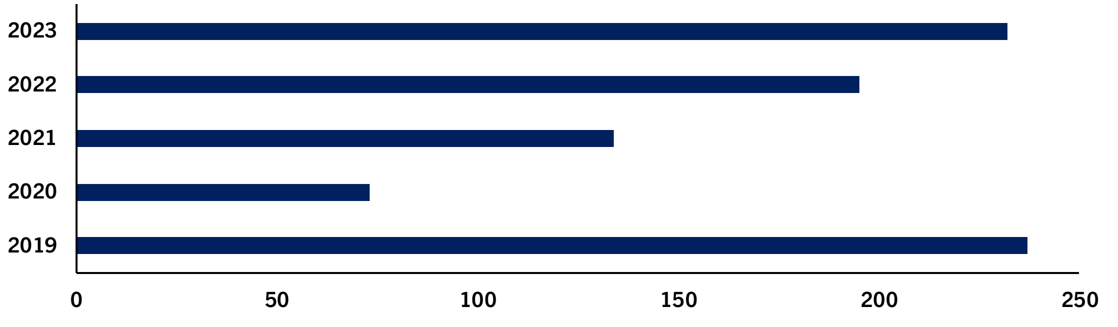
Subsectors

Airlines - Providers of passenger air transportation, primarily via airplane

Key Players - SouthWest (NYSE: LUV) & Delta (NYSE: DAL)

KPIs - Oil Prices & Revenue Passenger Miles

Delta Airlines Revenue Passenger Miles USD M[12]

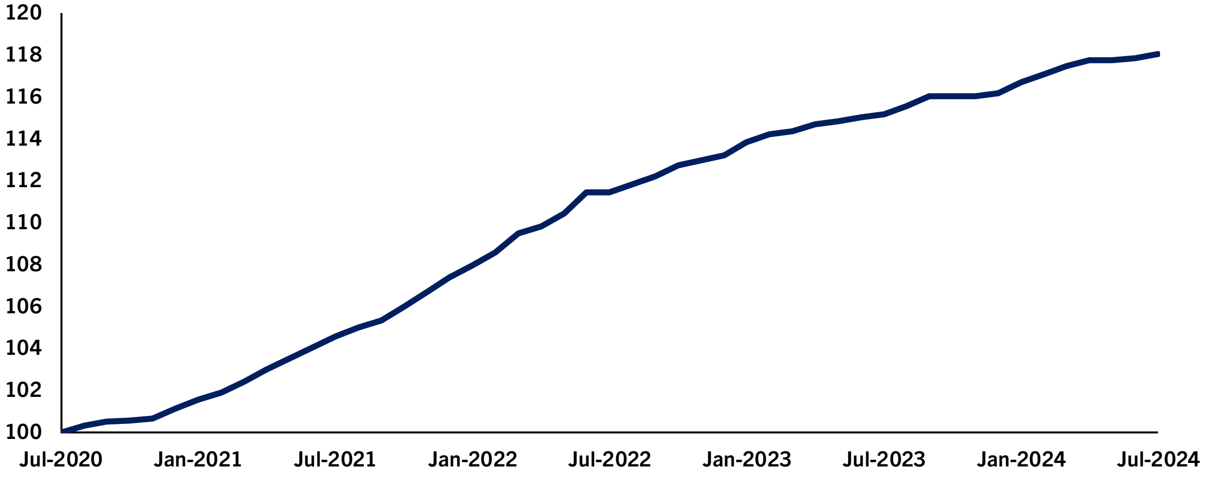


Trading Companies & Distributors - Companies which operate in the wholesale and distribution of a wide range of goods and services

Key Players - The Home Depot (NYSE: HD) & Lowe's Companies (NYSE: LOW)

KPIs - Consumer demand, PCE Inflation, Interest rates

US Personal Consumption Expenditures (Rebased to Jul-20)[13]



Subsectors

Commercial & Professional Services: KPIs

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): PAYX)

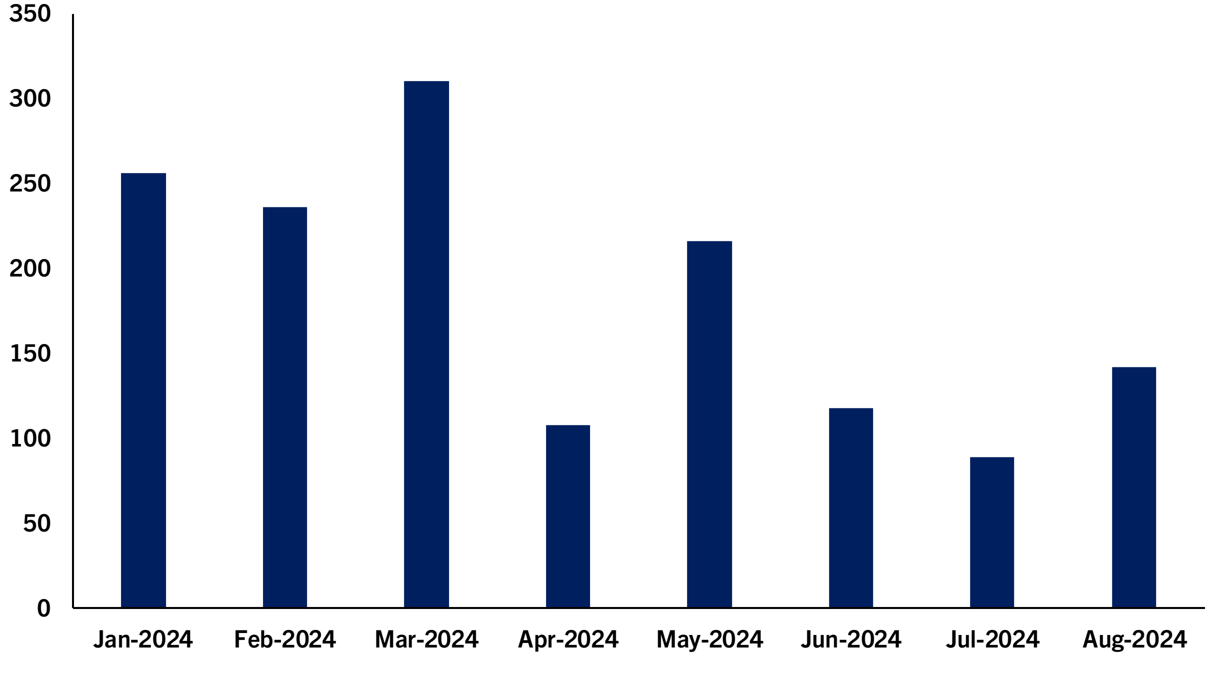
KPIs - Composite PMI & GDP Growth

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): PAYX)

KPIs - Services PMI & BLS Jobs reports

US Non Farm Payrolls (thousands)[14]



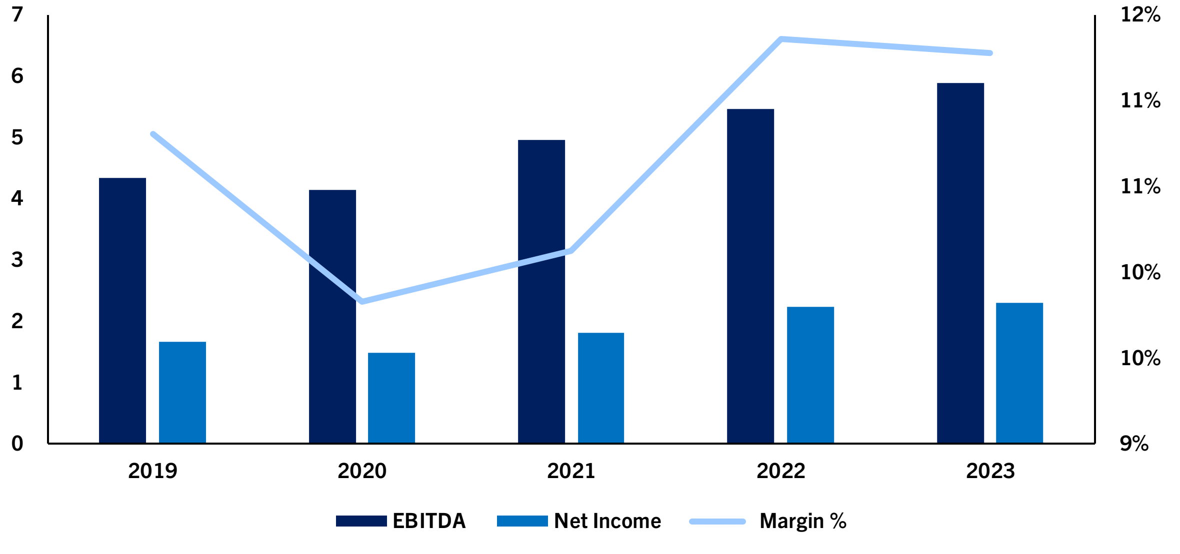
Current Holdings

Waste Management (NYSE: WM) - Hold

Waste Management is a US-based company engaged in the collection & disposal of waste. It has multiple reporting segments, but the majority of its ~20B revenue is derived from 'Collection' - long term contracts with Commercial, Industrial and Residential actors to manage waste.[15]

Waste Management currently trades at a premium to the wider market, with a LTM P/E of 27.7 vs 27.4 for the S&P 500. This premium is justified for three key reasons. First, Waste Management's long-term operational excellence. Second, its economic Moat. Third its recent acquisition of a key competitor, Stericycle.

Waste Management EBITDA vs Net Income USD B[16]



Waste Management: Operational Excellence

Operational Excellence is the idea that some companies are better managed than others. It can be shown by consistently increased revenue, profits, and dividends. Or indeed a combination of the three.

We look at these factors because they are proxies for free cash flow. Free cash flow (FCF) is the money left over to a business once it has met all its financial obligations. In short, it's the cash that a business generates. Waste Management is an excellent generator of cash.

Current Holdings

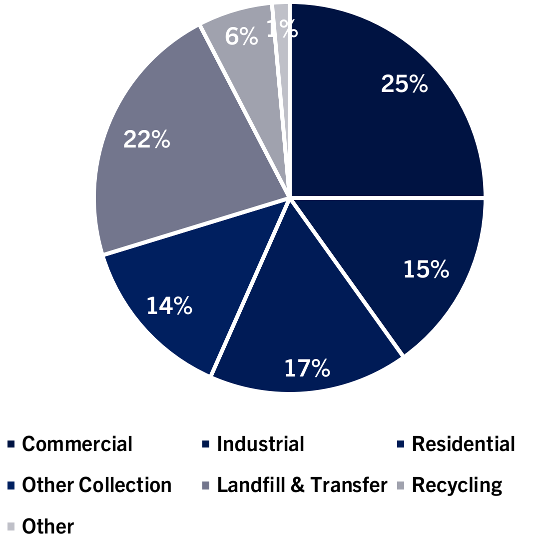
Waste Management: Economic moat

Economic moats are advantages that differentiate a company from its competitors. It could be a particular product, patent or way of doing business. All equities that are successful in the long term have some kind of an economic moat. The best have many.

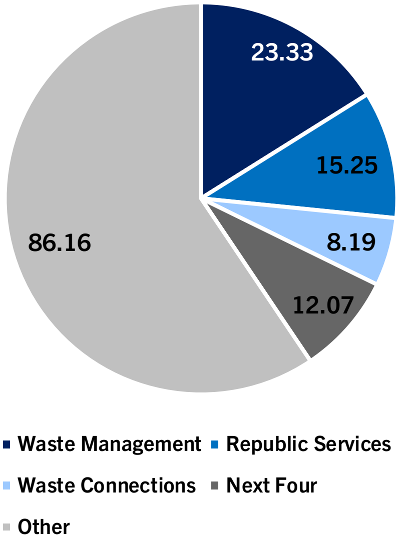
WM has two key economic moats. The first is its scale. The second is the difficulty in constructing new waste management infrastructure.

WM is the market leader in the US, with over 550 collection sites and 260 active landfills. This allows the company to offer reliable nationwide service, and benefit from cost synergies.[17] Following the acquisition of Stericycle, WM has increased its market lead within the wider industry, and in terms of revenue will be roughly equal to its next two largest competitors combined.

Waste Management Revenue Breakdown[18]



2023 US Waste Management Companies by Revenue USD B[19]



Furthermore, the infrastructure underpinning this revenue is extremely difficult to build in the current US regulatory climate. Environmental legislation means that landfill and transfer sites rarely receive permits, and those that do are far from residential or commercial operations. This makes the legacy infrastructure already in place more valuable.

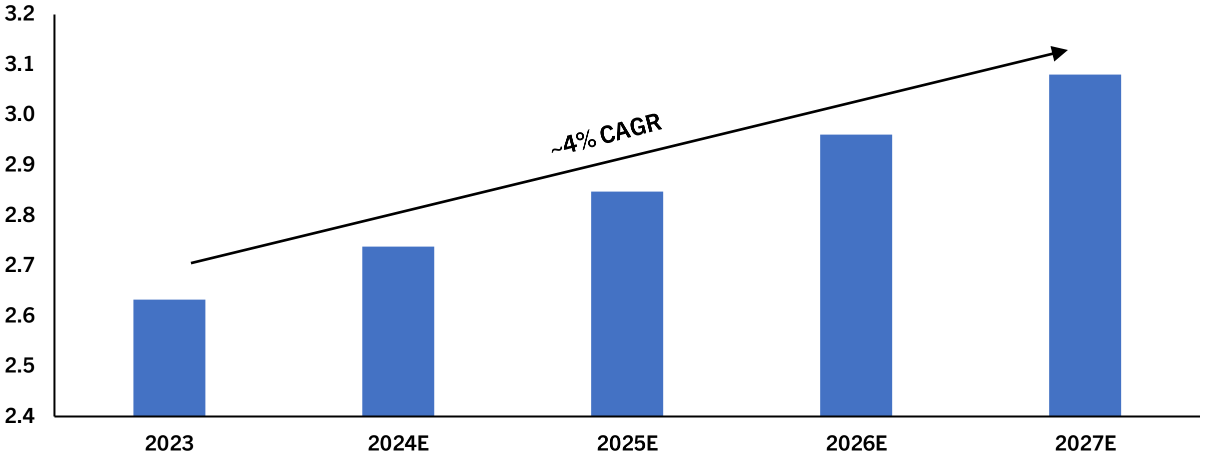
Current Holdings

Waste Management: M&A and Stericycle

Companies can grow in two ways. Organic growth comes from internal increases in revenue. For instance, a price increase that increases overall revenue is an example of organic growth.

Inorganic growth is derived from acquiring other companies. Usually, these acquisitions are justified in terms of synergies; larger companies can reduce costs through economies of scale. Acquisitions can also be strategic – a company might acquire a business to gain a foothold in a new market.

Stericycle Revenue USD B[20]



Most large Industrials equities will grow through a combination of these two factors. WM is currently completing the acquisition of Stericycle, a US-based competitor focused on the disposal of medical waste. The acquisition is expected to create $125M in cost synergies within a year of close.

Stericycle is good strategic fit for WM. Medical waste is a new line of revenue, one which will benefit from secular increases to medical spending in the US, due to an aging population.

Investing Themes

Industrials: Tailwinds

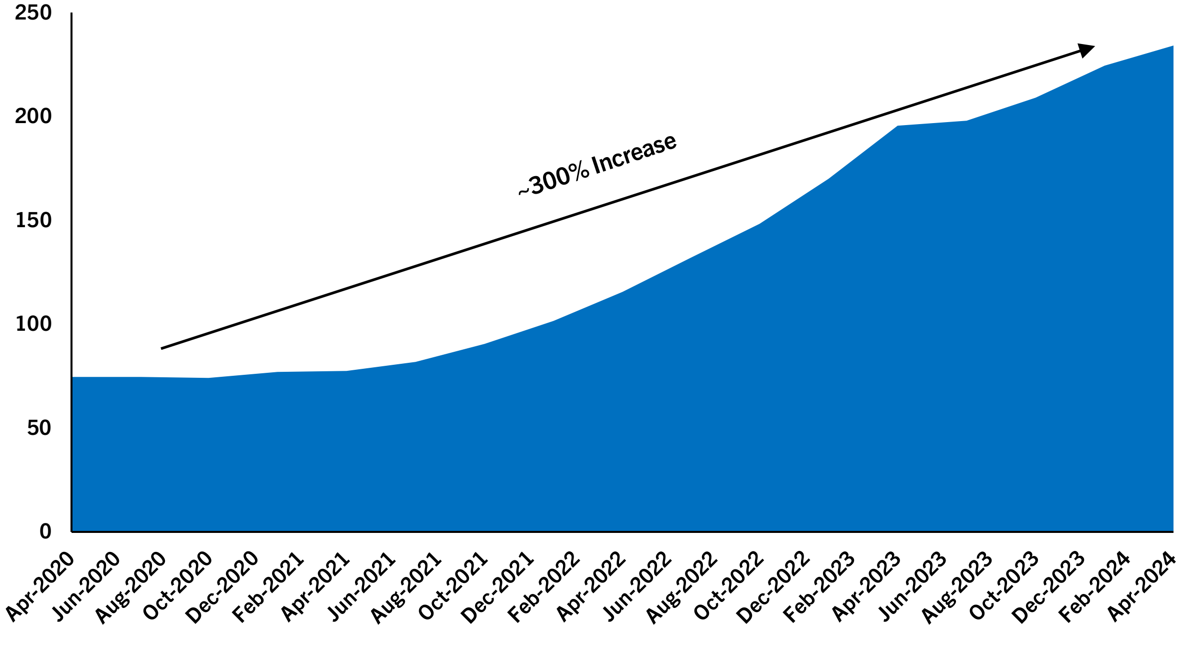
Tailwinds are trends that benefit an investment thesis. They are usually larger macroeconomic themes that will hold true for many businesses, sectors and economies. While themes like rate cuts and inflation affect all sectors, within Industrials there are two key themes. The first is US Industrial Policy. The second is exposure to the AI value chain.

US Industrial Policy: Nearshoring

Since the Inflation Reduction Act and CHIPS Act in the US, there has been a dramatic increase in investment into US domestic industrial manufacturing, as evident in the roughly fourfold increase since Q1 2020

This follows years of relative underinvestment, and this governmental support ties into all parts of the Industrials sector, since industrial companies are by and large the manufacturers responsible for putting the acts into practice.

US Manufacturing Construction Spending USD B[21]



There are multiple ways to gain exposure to this secular theme. One potential avenue is equipment manufacturers. These are the companies that supply the PP&E to both build and run new industrial projects. Some of the key players in this space are Honeywell International (NASDAQ: HON) & Emerson Electric (NYSE: EMR).

Investing Themes

AI & Automation: Capital Expenditure

Capital Expenditure is the outlay that businesses spend to invest in future productive capacity. Business to business capital expenditure (CapEx) is a key driver of revenue in the industrial sector. Currently some of the largest corporate capital expenditures are in the realm of AI, with Amazon, Google, Meta & Microsoft spending on average 40% of EBIDTA on AI related CapEx.[22]

While most of this spending is on chips and technology, much of it is further down the value chain. AI chips need data centres to house them, HVAC to cool them, and electrical equipment to monitor them. These are all areas where traditional industrial companies can gain exposure to AI.

Despite the questions surrounding the eventual profitability and ROI of AI that significantly impacted markets at the beginning of H2 2024, it is important to note that much of this spending is agnostic of whether AI eventually generates significant profits. Technology companies cannot take the risk of being left behind, so need to develop AI infrastructure.

This means the providers of said equipment stand to benefit either way – and crucially are not companies which will be left holding the pieces, should the AI revolution eventually prove ephemeral.

Risks

Industrials: Headwinds

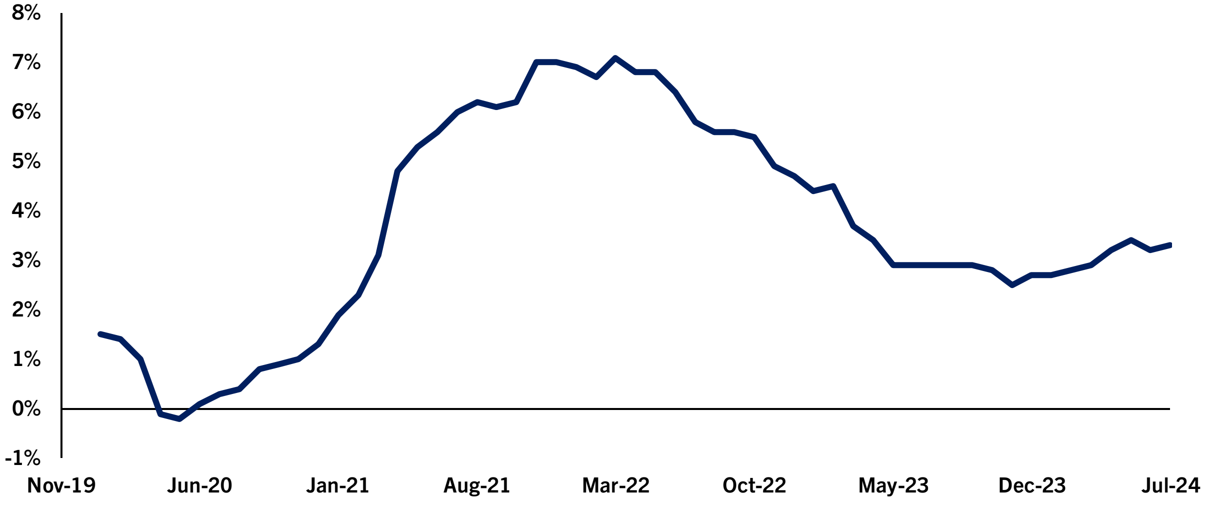
Headwinds are the opposite of tailwinds; they are concerns to an Investment thesis. Within the Industrials sector two serious headwinds emerge.

First, the Industrials sector is currently experiencing softening demand. Second the sector faces geopolitical risk - due in part to the concentration of global manufacturing in China.

Industrial Demand: Prices Rising, Orders Softening

While Industrial manufacturing construction is currently strong, the actual demand for capital goods is softening. This is due to long-term rising costs, and reduced pricing power Historically, producers have been able to pass on most of their cost increases to consumers. Now producers are instead losing pricing power. The Producer Price Index, or PPI, shows that the actual price received by producers for their goods has been relatively flat vs inflation for the past year.

PPI for final demand, 12-month percent change[23]



This is a reversal of the post pandemic trend, of rising inflation being met successfully by rising prices. Now however, even as prices rise, volumes are decreasing within the sector, leading to lower overall revenues. This is a reason why the ISM Manufacturing PMI has been in contraction for the past four months.

Therefore, companies within the sector with sufficient pricing power to weather cost pressures, both short- and long- term, are preferred.

Risks

Industrials: Geopolitical Risk

Even as reshoring and nearshoring continue to increase the manufacturing footprint of the US & EU, in 2023 more than 30% of the world's manufacturing was done in China.[24]

Industrials equities, even if they are listed in the US, continue to have significant exposure to China. This creates supply chain risks - particularly since tariffs against Chinese manufacturing have become a bipartisan issue in the US.

Even companies without a Chinese manufacturing footprint often still rely on Chinese inputs for production. Therefore, if there is a deterioration in US China relations, the Industrials sector overall faces a headwind.

Mitigants to this are companies with relatively stable supply chains, without significant exposure to risky markets. It is one reason Waste Management continues to be a part of our portfolio - its revenue footprint is entirely derived from the US & Canada.

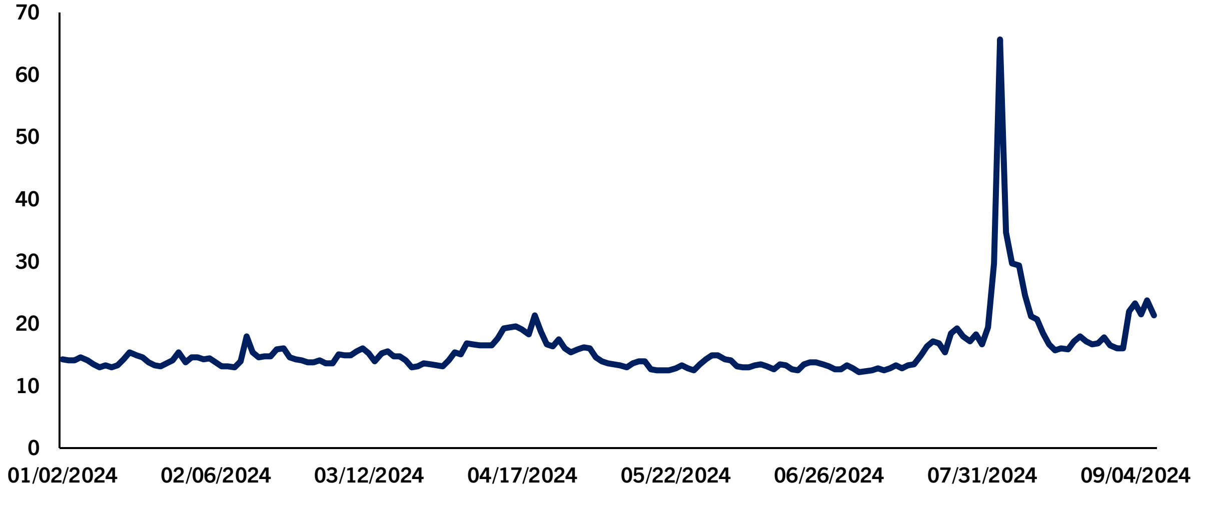
US Election 2024

Estimating the effect of the US election on the Industrials sector is difficult, for three key reasons.

First, both candidates have radically different views on policy – tariffs, taxes & trade will play out differently depending on the outcome of the election. This creates massive economic uncertainty, since it is difficult to make any long-term projection with the US election on a 50/50 knife edge.

This uncertainty, along with discussions over AI, is at least part of the reason why the public markets have been so volatile over the past quarter.

Cboe VIX Index[25]



Risks

Second, the market must deal with execution risk, in that both candidates could receive the presidency with a hostile house or senate. The candidates, their policies, and their ability to enact their plans are therefore all sources of uncertainty.

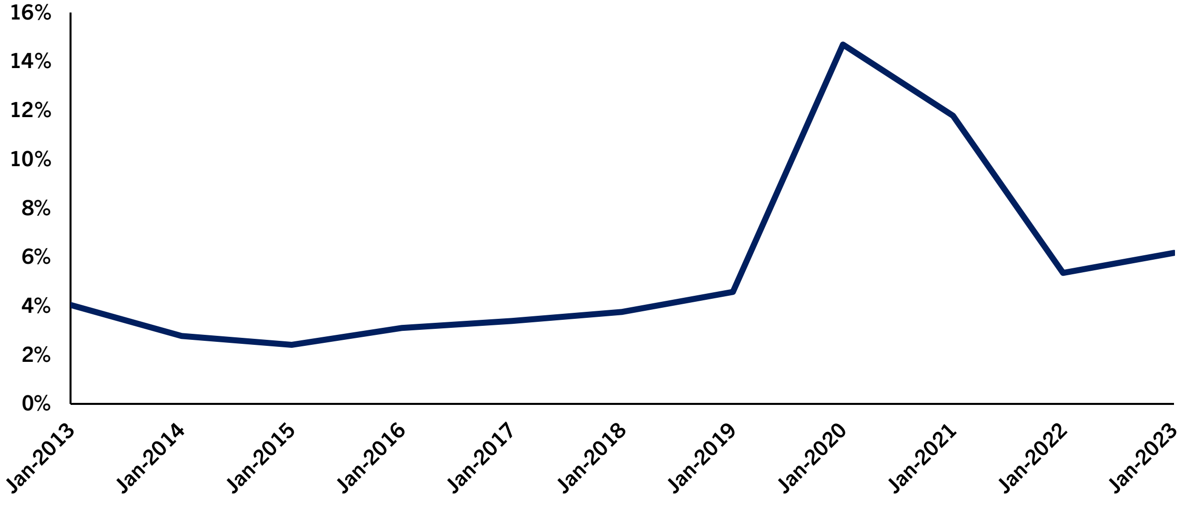
Third, even where the candidates do agree – on divesting away from China, controlling big tech & strengthening the middle-class – neither have yet offered a clear and concrete policy platform to work with. Key questions, for instance on the actual the implementation of policies like tariffs, remain unanswered less than two months out from the election.

Therefore, it is more useful to find where politics and policy agree, as themes that will remain consistent regardless of the election's result. With that in mind, in the Industrials sector there are two key commonalities

First, both candidates are likely to pursue Industrial policy that puts America "first". This makes a strategy based on finding and holding American firms, with American manufacturing capacity and American revenue, attractive.

Second, neither candidate has motioned to significantly cutting spending. This means cuts to the historically high US deficit are unlikely – and that the indirect subsidy to the Industrial sector that comes as a result of federal deficit spending is likely to continue.

Federal Deficit as Percent of GDP[26]



Therefore, while uncertainty around the election will stagnate economic activity in the near term, in the longer term the US & the Industrials sector remains an attractive area of investment – especially for those willing and able to weather pre-election uncertainty and hold for the longer term.

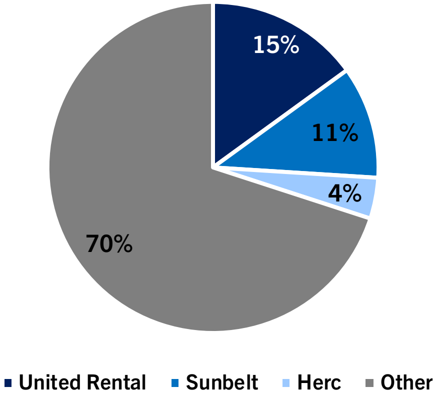
Buy-List

United Rentals (NYSE: URI)

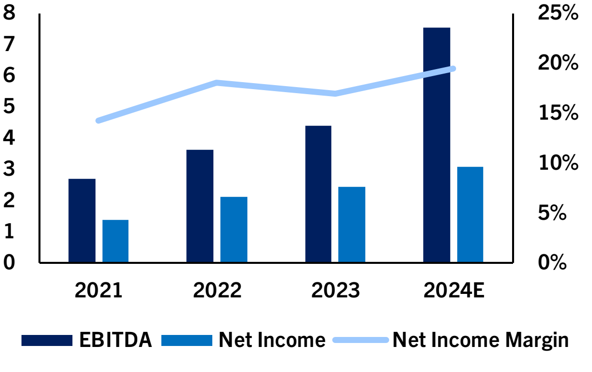
United Rentals is an equipment rental company. It operates in two segments, General Rentals and Specialty. URI holds ~15% of the commercial equipment rental market in the US and is a market leader in the breadth and depth of its equipment offering. A one stop shop, URI can fulfil essentially all end user verticals.[27]

Key is that URI is not an equipment manufacturer – it is a pure play on rental, which is an attractive way to tie into manufacturing within the US. without taking the risk of difficult product development and expensive CapEx

US Equipment Rental Market Share[28]



URI EBITDA vs Net Income USD B[29]



URI's market leading position is also a deep moat against competition. With over 1600 physical branch stores and $21B in rental fleet, the barriers to entry to compete with URI in profitable and scaled equipment rental are enormous.

United Rentals: Operational Excellence

United Rentals continues to be an excellent generator of cash. This revenue growth comes from both its pricing power in the rental space, as well as inorganic growth via acquisition. The company is completing two current acquisitions, expected to add significantly to its expected 2024 & 2025 and EBIDTA & Net Income.

As with most M&A, a key question is the financing used to complete these acquisitions. Both were completed on debt, and as of June 2024, URI has roughly $13.9B in notes outstanding, all of it in fixed rate vehicles at a weighted average interest rate of 4.7%. This translates into roughly $650M in annual interest repayments, representing a significant drain on profitability.[30]

Future cashflows & synergies will cover URI's repayment pathway, and the company can enhance profitability by paying down its debt. Therefore, a more pressing question is valuation: what is a fair price to pay for the company?

Buy-List

United Rentals Valuation

There are broadly two methods to valuation – the first is intrinsic. Intrinsic valuation looks at a company on its own merits, without reference to external competitors.

The second is relative. Relative valuation methods value companies with reference to their competitors, or otherwise similar companies. Valued on a comparable multiples basis vs its direct competitors, URI trades at a slight premium, with an implied fair value 8% below its current price.

Comparable Multiples Valuation

	P/E	Fwd. P/E	P/B	P/S	EV/Revenue	EV/EBITDA
AHT	19.40x	16.90x	4.10x	2.70x	3.70x	8.30x
HRI	11.10x	9.30x	2.80x	1.10x	2.50x	9.80x
WSC	38.10x	18.30x	5.80x	2.90x	4.40x	13.60x
Median	**19.40x**	**16.90x**	**4.10x**	**2.70x**	**3.70x**	**9.80x**
URI	18.40x	15.50x	5.60x	3.10x	4.00x	11.90x

Upside Analysis

	P/E	Fwd. P/E	P/B	P/S	EV/Revenue	EV/EBITDA
Median	**19.40x**	**16.90x**	**4.10x**	**2.70x**	**3.70x**	**9.80x**
URI	18.40x	15.50x	5.60x	3.10x	4.00x	11.90x
Multiple	1.05x	1.09x	0.73x	0.87x	0.93x	0.82x

URI is therefore currently an expensive stock to buy, at least on a comparable basis. This gives the IC two options when it comes to deciding on whether to create a position in the company.

The first option would be to buy into the company. Given that expanding US domestic manufacturing capacity is such a strong tailwind within the sector, there is a case for buying URI as way to gain exposure to US Industrial construction – a vertical that makes up half of URI's total revenues.[31] URI's scale ensures that it could take advantage of the opportunity.

Upside/Downside

Average Premium	0.92x
Downside	**-8%**

The second option would be to wait. While the company is attractive, we have almost no margin of safety when entering in at the current price. Near term catalysts for a price correction include the coming US election & further softening of Industrial demand.

Neither would alter URI's growth story but could impact its price in the short term. Until then, it remains an excellent business, but one that currently trades at above its fair value.

Outlook for the Year

Industrials: Capital goods in focus

As a sector, Industrials tends to move slightly ahead of the curve. Industrial companies are some of the first to feel any kind of economic weakness, and their orderbooks are closely tied to overall economic strength.

Currently there are signs that the economy is softening. From the PMI to the PPI, large capital goods manufacturers are facing both supply and demand side issues.

Our Waste Management position, in the Commercial & Professional services segment of the Sector, is partially insulated from these pressures. Our potential United Rentals position would similarly be protected; despite economic issues, the US government continues to subsidize the construction of domestic manufacturing capacity, and URI's equipment will be in high demand.

The question therefore is where will capital goods manufacturing go over the next year? Here US rate cuts provide a potential answer – as of September 2024 a cut looks inevitable.[32] This could provide the stimulus needed to justify a position in a capital goods manufacturer.

Rate cuts are particularly attractive in the context of the US election – even in the two polar worlds on offer at the ballot box this November, the Fed & its fiscal policy remains independent.

Finally, there is the question of an increasingly polarized world, one in which globalized & disparate supply chains are increasingly being called into question. Global shipping costs, which are a proxy for the ease or difficulty of global trade, are almost four times their historic averages – and are unlikely to fall in the near term.[33] This is a vulnerability of the sector – multinational companies have multinational concerns.

Therefore, even a well positioned manufacturer needs to display a few key characteristics. Demonstrable pricing power to offset rising costs. A stable supply chain, preferably one relatively insulated from geopolitical risk. And most importantly, a history of operational excellence.

Investment theses are case by case, and each company is individual. However, these are the key features of the sector's investment approach – and they will continue to be applied as the year goes on.

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