Global Industrial Outlook: Frogs' Legs, Bratwurst and the Bear

By Brian Langenberg, CFA

First-quarter results are in (bad weather) and summer will prove more interesting than either the market or the fall elections until after Labor Day. But much is happening! Three areas for discussion in this installment:

- ***Current outlook***
- ***Big deal with implications***
- ***Geopolitics: How Russia, Ukraine, China affect you***

Current Outlook

Broadly speaking, we are seeing "more of the same" with stability in energy, growth in aerospace, North American truck (PACCAR, Cummins), and global automotive. Mining is (*yes, still*) awful—but stabilizing.

Weather conditions in North America disrupted construction equipment, but every company saw a bounce-back starting in April that appears genuine.

While weather caused a slew of revenue and EPS misses vs. expectations, management commentary was broadly constructive to positive.

Oil & Gas: In April's issue we told you overall capital spending will remain stable this year, with particular strength in downstream (refining), midstream (pipeline infrastructure), while upstream would decline perhaps (1-3%) overall. Within the North American market we see midstream -related activity remaining strong—if slowing— after this year, but overall in solid demand.

Mining: Continuing to see signs of a thaw and stabilization beyond 2014. Not this year. Capital spending in the mining sector will fall another 25-35% this year and can fall further in 2015. Near-term, high-utilization will drive continued stability in consumables and service. U.S. coal producers still having a difficult time, but rising metallurgical and thermal coal demand wins in the end.

		SURPRISE		
COMPANY	**TICKER**	**REV**	**EPS**	**PUNCH LINE**
OIL & GAS				
Emerson	EMR	(2)	(9)	Strength in O&G, Chemicals. Power generation (CAT) improving.
Flowserve	FLS	(6)	+4	Weak quarter for orders, underlying strength in end markets.
MACHINERY				
PACCAR	PCAR	+11	+1	Rising outlook for North American Class 8 truck.
Cummins	CM'	5	+8	N. American Truck drove EPS beat and raise. Medium, light duty also.
Caterpillar	CAT	+0	+15	Strong construction, Mining bottoming, improved Power Generation.
United Rentals	URI	(0)	+27	Volume, price, time utilization all improving.
Oshkosh Corporation	OSK	(1)	(5)	Strong ex defense. Improving municipal balance sheets also.
Terex Corporation	TEX	(3)	(14)	Weather, crane weakness.
Deere & Co.	DE	(4)	+6	Ag sales off (12%); lower US farm cash receipts.
Manitowoc Company	MTW	(7)	(15)	Weather socked 10 crane sales, delayed projects and shipments.
POWER GENERATION				
Wartsila	WRTB.IX	+6	+6	Good activity.
Alstom	ALO.FP	+2	(19)	Disappointing results. In play (GE, SIE).
General Electric	GE	(1)	+3	Strength in gas turbine, wind, Oil & Gas, Commercial Aviation.
Siemens AG	SIE	(3)	(14)	Restructuring to focus on power. Alstom bid could create disruption.
EURO MACHINERY				
Atlas Copco	ATCO.B.IX	(2)	(6)	Compressor stable, Mining & Rock remain ugly.
SKF	SKFB.SS	(2)	(6)	Strength in Europe, LatAm, MEA. Weather impacted N. Am.
Sandvik	SDVKF	(4)	(13)	Miss.
Alfa Laval	ALFA.IX	(7)	(32)	Marine & Diesel improving off low base.
AEROSPACE				
Boeing	BA	(0)	(18)	Strong commercial outlook.
Airbus	EAD.FP	(4)	(8)	Defense restructuring continues; strong commercial outlook.
Bombardier	BBD.B	(4)	(29)	Delays in CSeries. Rail outlook solid.
TXT	TXT	(6)	(12)	Small/Medium business jets remain soft.

Aside from indisputable facts and figures, the opinions and conclusions are the author's and do not necessarily reflect the position of Randall Publications LLC.

Power generation: There is a *reason* General Electric is seeking to buy the coal turbine assets of Alstom. Band-Aid shipments (wind turbines) are up, along with gas, which is trending upward.

Transportation infrastructure: No change. U.S. infrastructure spending will remain flat until *late* 2016 at the earliest, as it would require bipartisan support and willingness to spend on *infrastructure*.

Water & Environmental: Municipal budgets and tax receipts are modestly improving, though home price recovery has slowed. Indirectly, a 10-15% increase in home prices over the next 2-3 years would drive a dramatic increase in construction equipment demand.

Machinery: *North American Truck demand is accelerating* as evidenced by strong results and guidance from Cummins, PACCAR and others. *Construction equipment* demand will remain solid, owing to weak comparisons and low channel inventories, despite the 1Q weather impact which resulted in numerous delayed projects. Things are less rosy on the farm; Deere reported a (12%) decline in Ag equipment during its fiscal 2nd quarter and U.S. farm cash receipts are down.

Consumer (auto, appliances): Global automotive demand remains quite good, and within the U.S. market the average fleet age is over 10 years—supporting a strong multi-year demand outlook that will improve over the next 2-3 years with gradually improving home prices (i.e. consumer equity). Housing demand is being impacted, on the margin, by slightly higher interest rates, but more importantly, weather delays that we consider transitory.

Aerospace/Defense: We flesh out a long view, shortly, that is not broadly accepted or recognized by most, but which seems increasingly obvious to our more astute contacts. The near-term punch lines are as follows: Commercial aerospace is and will remain strong in original equipment, MRO and aftermarket spares, though growth rate will moderate. On the defense side one should expect a slower rate of decline in the near-term within the U.S. Growth is coming—if not after the 2016 election cycle—for a host of reasons, all of which relate to a) global reality and b) recent underinvestment.

Big Deal with Implications

Pay close attention if you do business directly, or indirectly, with General Electric (Power & Water), Siemens (Energy, Rail), Bombardier (Transportation), or Alstom.

Sometimes size matters—and in the global power generation arena a few major Western players compete in global power generation—primarily meaning coal, gas and nuclear. Large global growth projects also pressure these manufacturers for price and terms, and a product hole can become problematic.

As we write this column the final outcome of negotiations involving GE, Siemens, Alstom and the French government are unclear, but one of two outcomes appears likely: the steam turbine assets of Alstom will end up with either General Electric or with Siemens.

If General Electric wins the business, existing suppliers on the gas/turbine or oil-and-gas side should get opportunities at more content in steam turbines. We see little disruption by combining the two businesses, as GE gets a broader portfolio but in turn may curtail R&D spend on its current coal plant technology. Conversely, a Siemens/Alstom combination would lead to inevitable supplier consolidation, given the significant product and geographic overlap. This is a greater challenge for those with a strong European presence.

Rail could also be impacted in an Alstom/Siemens combination that merges their passenger rail assets. Suppliers to both will need to navigate supplier rationalization moves as neither will want to fire their own people and cost cuts must be found. Alstom suppliers should note that 60-70% of Bombardier Transportation revenue is in Europe and dealing with a larger, stronger consolidated competitor could prove challenging.

Geopolitics: How Russia, Ukraine and China Affect You

The best wars are those that do not get fought—either because people are nice (on occasion), are reasonably satisfied (this varies) or are smart enough *not* to start something (often requiring credible visual aids and political/national backbone).

For example, the USS Wisconsin (BB-64), decommissioned in 1991, was a fantastic visual aid. It was big (887' long, 106' beam, 58,000 tons) and credible (capable of sending 9 tons of high explosive behavior modification up to 23 nautical miles every 30 seconds). And the missiles, of course.

She isn't coming back—but we need more ships (about 300 now vs. 571 at the 1980s peak), and bigger (Littoral Combat Ships, a.k.a. utility infielders do not scare anybody).

DEFENSE SPEND / GDP	U.S.	U.K.	GERMANY	FRANCE	JAPAN
1970	8.0%	5.8%	3.3%	4.1%	0.8%
1980	5.5%	5.1%	3.3%	4.0%	0.9%
1990	5.3%	4.1%	2.8%	3.6%	1.0%
2000	3.1%	2.5%	1.5%	2.5%	1.0%
2010	5.4%	2.7%	1.4%	2.0%	1.0%
2012	**4.4%**	**2.5%**	**1.4%**	**2.3%**	**1.0%**
Versus 1980:	**80%**	**49%**	**42°A**	**58%**	**111%**

Without these visual aids and political/national will people can misbehave. Recent examples include:

On May 25th a Vietnamese fishing boat was sunk by a Chinese fishing vessel near a Chinese deep-water oil rig. Lest you think it was an accident, not even twenty years ago, unmarked Chinese naval vessels were conducting raids on merchant ships at sea, sometimes with deadly consequences.

Ukraine, Crimea, Europe—Putin will get most of what he wants—Crimea, influence over the Ukraine, intimidation of most neighbors—Europe is throwing Ukraine under the bus.

In a nutshell: the U.S. electorate is not focused on global engagement, Europe is picking economic interests over extended confrontation, and China is the fastest growing Asian military presence.

Paradigm shift is not far off and you should not ignore the following opportunities in your longer-range growth strategies in both the U.S. and Europe:

The U.S. spends at 4.4% of GDP but the navy in particular is short on real combat ships. Period. Look for opportunities. Electro-magnetic gun—the United States Navy recently tested an EMG, firing a projectile 100 miles at Mach 7. By way of comparison, the USS Wisconsin could shoot its guns 23 miles. It will be tested at sea in 2016 and did we mention that gun systems have gears? Go make them!

Europe realizes it no longer has its (U.S.) sugar daddy on defense—U.S. lack of engagement coupled with Putin's territory grab has brought a message home to a continent highly reliant on Russian gas, and militarily unable to defend itself. Europe is now quietly forming plans for a defense organization outside of NATO because of the realization they must fend for themselves. Three countries matter in terms of defense spending—UK, Germany and France—collectively, over $7 trillion in GDP and spending at 40-60% of already underfunded cold war levels. They will never hit the 4-6% range required to support power projection because it is not needed, but 1.4-2.5% doesn't cut it if you want tough guys to take you seriously. Poland is the bulwark but these three need to pay for it. A 1% increase in defense GDP translates *into $70 billion per annum,* of which 1/3 would be equipment. Find ways to get at European defense business.

Japan prefers to make their own stuff but get in on weapon systems and platforms they are likely to buy. They are going to a) increase overall spending and b) emphasize sea power projection.

The other angle is playing the energy security side. Europe has discovered that if you seek to close coal plants and nuclear plants and opt to buy Russian gas, you leave yourself exposed. Likely outcome is, sooner or later,U.S. exports of natural gas and thermal coal to Europe. Find ways to get in front of the infrastructure build out. As noted, U.S. midstream companies (pipelines) are investing to get the gas moved to population and the coasts. Terminals and ships need building.

Focus Company:

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Sales	**9,633**	**7,806**	**7,022**	**7,932**	**8,871**	**11,571**	**11,257**	**13,901**	**11,666**	**8,726**	**9,179**	**8,787**
EBIT (Adj.)	(772)	164	305	543	711	1,007	1,248	1,468	1,052	850	959	930
Invested Capital			1,436	1,351	1,458	1,287	1,469	2,204	3,118	2,070	2,264	2,774
Tangible Capital			(1,373)	(1,445)	(1,529)	(1,965)	(1,899)	(1,177)	(550)	(1,138)	(957)	(130)
After-tax ROIC			**15%**	**28%**	**34%**	**55%**	**59%**	**47%**	**24%**	**29%**	**30%**	**23%**

Alstom (ALO.FP)

Alstom currently operates in two areas—power—including thermal (coal, gas, nuclear), renewable (mostly hydro) and transmission grid—represents about 75% of sales and the balance is rail. We will focus on thermal ex nuclear, which is the piece everybody wants.

Alstom is considered a "national champion" by the government of France, but in fact is in financial straights for the second time in just over ten years. While returns on invested capital within the thermal segment remain outstanding—2013 was a weak year with "only" a 23% return on invested capital. Shown below is a 12-year history.

The key takeaway here is thermal segment revenue (including nuclear) is only 63% of peak, which means 60% growth potential just to hit 2010 revenue. A combination of growing global power need, reality that turbines and solar won't carry the load and aging plants in the U.S. and Europe augur well for growth—particularly if General Electric gets the business because they can both grow their service model in Europe but also participate more effectively in the U.S.

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