Global Industrial Outlook: Game Changer

Brian Langenberg

The number one question today is: are the current low oil prices a near-term or structural development?

We don't know. And neither does the U.S. Oil Sector.

- Saudi Arabia is continuing to pump; this is a geopolitical move.
- Technology has reduced cost and increased energy access — a structural fact.
- Low prices + crushing debt = bankruptcies among small producers.

Add it up and you have lower confidence and lower spending.

July 2013 — Oil @ $100: Prince Alwaweed announces that oil price structurally going down; nobody is listening.

May 2014 — Oil @ $100: Russia, Iran, ISIS behaving badly, while U.S. doing nothing. Saudis notice.

Nov 2014 — Oil @ $75: Saudi's deploy Weapon Alpha — i.e. oil production — to (take your pick) fight an economic battle against the above and — possibly — U.S. fracking.

Feb 2015 — Oil @ $50: Oil has traded more or less between $40–$60-per-barrel all year, and a 50% price cut should lead to 50% (or more) capex cuts; thus far we are seeing 25%–35% cuts. It will get worse; producer bankruptcies are coming.

We are beginning to reconsider our long-term position on oil prices. At the very least, your construction equipment, power generation and mining customers face a continuing cyclical challenge.

The structural challenge is something else. With respect to natural gas, the question is what is the true, fully loaded cost to explore, produce and transport energy sourced through hydraulic fracturing? Whatever that true cost is will likely prove the "high-end" price cap on oil longer-term and, with that, an important factor with respect to the energy sector's demand for heavy machinery over time.

Additionally, to the extent the energy boom of the last few years was a "bubble" — history shows that bubbles do not reflate.

July 28, 2013: Billionaire investor Prince Alwaleed bin Talal is reported to have written an open letter to Saudi oil minister Ali al Naimi, warning that Saudi Arabia must diversify its revenue sources because of the impact of shale gas extraction on the oil industry globally. Oil was trading between $100-$105. Again, nobody (at least whom I know of) was listening.

May 2014, Oil ~ $100: Frog Legs, Bratwurst and the Bear

Capital spending will remain stable this year, with particular strength in downstream (refining) and midstream (pipeline infrastructure), while upstream will decline perhaps (1%–3%) overall.

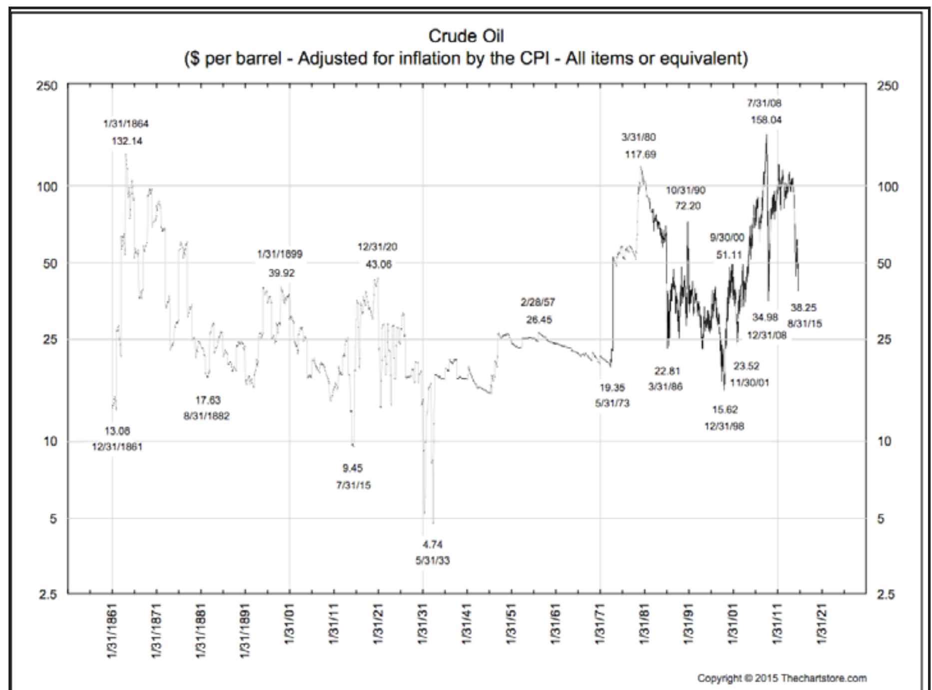
August 2014, Oil ~ $100: Das (Human) Kapital

We were fortunate to meet with the management teams of 16 major companies from offshore drillers like Transocean, to oil field services provider Dresser-Rand. We also spoke directly to Exploration & Production companies. In a nutshell this is what we are communicating:

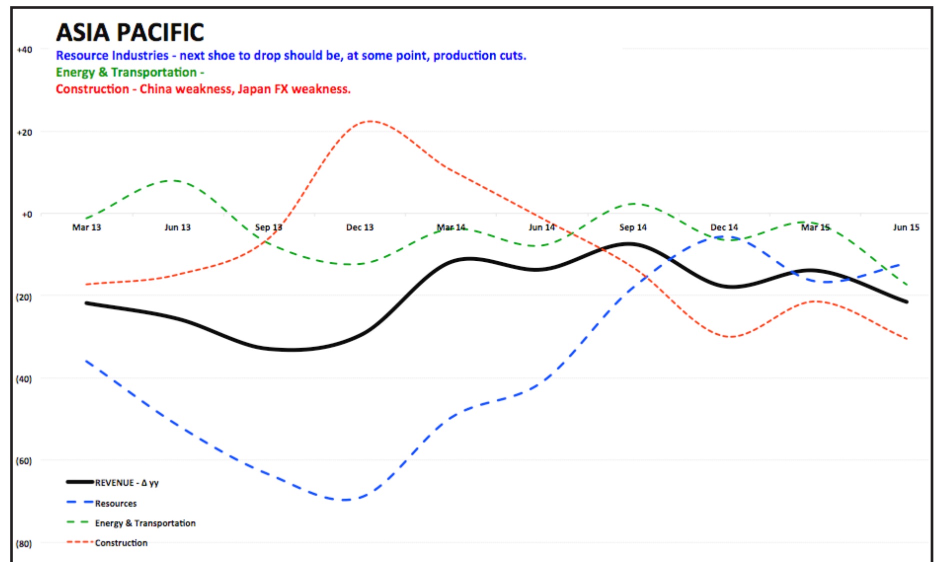
- **Off-shore.** Poised to accelerate in 2015.
- **Mid-stream** (pipelines). Strong expansion continues to get upstream energy supplies to market.
- **Refineries**. Because of condensate export approvals, expect rising demand for new, modern, LNG/LPG tankers and infrastructure.

Our writing through August pointed out rising geopolitical issues — Russia, Ukraine in particular — and how it will drive rising European defense spending over time.

We did not anticipate that Saudi Arabia would deal with ISIS, Iran, and Russian challenges with its No. 1 weapon: oil production



Extended timeline for Oil & Gas



November 2014, Oil ~ $75: Houston, we have a problem

At this juncture it became clear the Saudis would maintain production to crush oil price. The only debate was whether they were going after Putin / Iran (our view) or U.S. fracking (a la Prince Alwaweed). Either way, we were early in saying lower oil price is bad for the sector and that 2015 oil related capital spending would be significantly lower with this passage:

"Netting it all out though, oil price down (25%) = (25%) lower industry revenue = bad for you. *Most of your customer base is claiming it will have little impact. They are wrong."*

February, 2015, Oil ~ $50: Oil slick, currency headwinds challenge growth

The general consensus is about a (25%) reduction in 2015 capital spending, which seems right ***but can worsen in 2016*** should oil price not recover.

March, 2015, Oil ~ $50: Oil slick, currency headwinds worsen

The general consensus remains for a (25%) reduction in 2015 capital spending by global oil companies, but those forecasts implicitly assume at least some recovery in oil price from curtailed exploration activity. Unfortunately, cuts in natural gas fracturing — even 4%–6% in a week — do not boost oil price.

One month ago WTI (West Texas Intermediate) was at a "depressed" $52. Now we are looking at $45; expect more capital spending cuts.

May, 2015, Oil ~ $60: Slow growth ahead; farm belt can't help

The Saudis continue to step on the gas, driving and keeping prices low; and as a result North American capital spending continues to decline.

Huge capex cuts in upstream exploration and production drove a number of weak first quarter results for industrial companies, and we see no respite for the next two to four quarters before stabilizing at a lower spending level.

July, 2015, Oil ~ $50: Kind of sluggish

Oil had rallied from about $50 to $60 over the past month (I like round numbers) but have since round tripped. Expect further, deeper capital spending cuts in the U.S. oil sector to continue affecting demand for large capital equipment.

Assuming Iranian oil comes back into the global market, prices will be further pressured. We continue to see negative comps for the next two to four quarters before stabilizing at lower spending levels.

Opportunities remain. Low commodity prices hurt commodity producers and their equipment suppliers — but also benefit these major sectors:

- Aerospace
- Auto production
- Non-residential construction
- Residential construction
- Consumer discretionary

Construction equipment is getting hit near-term (equipment flowing out of L&G sector), but on the flip side lower raw material prices make large construction projects more affordable.

We anticipate no substantive improvement in manufacturing activity. Not in the U.S., nor internationally. Headwinds include oil price and commodities in general (down), and the U.S. dollar (up). Expect further, deeper capital spending cuts in the U.S. oil sector to continue affecting demand for large capital equipment.

China's stock market meltdown is their problem, not our problem. China's stock market rocketed upward on fundamentals — not economic acceleration — and the opposite is now true. In fact, China has proven a weak market for commodities and capital equipment for some time. Shown here is Caterpillar's "core" revenue trend for Asia Pacific over the past two and a half years:

Construction equipment weakness reflects excess supply and possibly market share loss in China; Resource Industries ties more closely to Australia/NZ but indirectly also reflects China.

The weakness is broad-based; Rockwell Automation core Asia Pacific revenue has remained at or below 5 percent since June 2014 and United Technologies' Otis Elevator unit has reported flat or down China elevator orders for the last five quarters. The point is that the weakness is old news, while the headlines are about their capital market excesses.

The rest of the world is hardly doing great — updated outlook for key geographic regions:

U.S. remains the safe, modest growth bet. Weakness abounds in commodity-related sectors — e.g. oil, coal, and farm equipment — but fundamentals remain positive for non-residential construction, consumer durables (auto, housing) boosted by gradually improving employment.

Europe. The weaker Euro benefits exports, lower commodity prices and slowing China growth are headwinds. Life will go on. Modest growth will continue.

Middle East. Right now, Saudis are investing to keep their mature fields working; incremental growth in defense spending is likely.

Latin America. Mexico continues to grow, and capital investment in the auto and aerospace sectors remains strong. Brazil, Argentina — much of the region — is toast.

China. No longer a huge growth market for outside players. Costs, business risk, and military belligerence are up and the mask is off. I do expect the nation's economy will grow 5–7 percent — but with greater wealth capture from domestic players. It will still be a good place to do business, but not a *great* place to do business.

The End Market Picture is Likewise Mixed

Oil & Gas. We believe it is going to get worse.

Mining. Awful, plunging toward hideous.

Power generation. Sounds like GE will be able to close on Alstom deal. Devil is in the details regarding what they must to concede. Supplier memo: Have your helmet on and the chinstrap fastened for that upcoming "partnership" discussion.

Transportation infrastructure. More stability through 2016–2017 with, perhaps, modest growth. I remain convinced that lower oil prices will lessen the growth profile for oil shipped by rail. Conversely, a new President in 2017, low commodity prices (steel, cement, energy), and dilapidated infrastructure would, you think, be a growth catalyst. Let us hope.

Machinery. Everything ex-truck stinks. Construction equipment is soft, agriculture will remain weak and mining is hideous. Only silver lining — and not enough to off-set — is growth in non-residential and residential construction.

Consumer (auto, appliances). Same story; auto benefitting from old cars, improving employment and capital investment in Mexico. Residential construction growth should help appliances.

Aerospace / Defense. Global commercial aircraft demand is rock solid driven by economic growth, low fuel prices and strong capital markets. Cargo is also picking up. One offset is that Boeing 747 orders remain weak and there is chatter about the program's future as the world demands more narrow body and the A380 makes inroads. Defense spending has troughed in the U.S. and international growth strikes us as likely though with little benefit to the U.S. industrial base.

Focus Company: AGCO (ACGO)

AGCO is a distant No. 2 in North American farm equipment behind John Deere and is far more leveraged to global conditions. As such weaker U.S. demand is more of an annoyance

	2012	2013	2014
EAME	$5,074	$5,482	$5,158
	475	558	500
N. America	$2,584	$2,758	$2,414
	260	326	219
S. America	$1,856	$2,040	$1,663
	162	213	134

than huge challenge. Operationally, the company has succeeded in driving North American margin to 10 percent or better in two of the last three years.

Still, weak conditions are also a challenge for AGCO, particularly as S. American operations are suffering and the strong dollar has hurt currency translation back to the company.

We just returned from meetings at the Farm Progress Show in Decatur, IL, including a presentation and booth tour by Bob Crain, SVP & general manager for the Americas. There was silver lining, given low crop prices and excess dealer inventory. The key takeaway was that while dealer inventory was down (12 percent) y/y as of end of July with production cuts and targeted marketing programs planned to make further reduction.

Finally, whole farm sector is under the weather — and in North America that includes Deere, AGCO and CNH Industrial — all of which cite excess inventory and lower used prices. None see a rebound in 2016. And neither do we. **PTE**

Brian K. Langenberg, CFA, has been recognized as a member of the Institutional Investor All-America Research Team, a *Wall Street Journal* All-Star, and *Forbes/Starmine* (#1 earnings estimator for industrials). Langenberg speaks and meets regularly with CEOs and senior executives of companies with over $1 trillion in global revenue. His team publishes the *Quarterly Earnings Monitor/Survey* — gathering intelligence and global insight to support decision-making. You can reach him at *Brian@Langenberg-llc.com* or his website at *www.Langenberg-LLC.com*.

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