Global Industrial Outlook: Houston, We Have a Problem

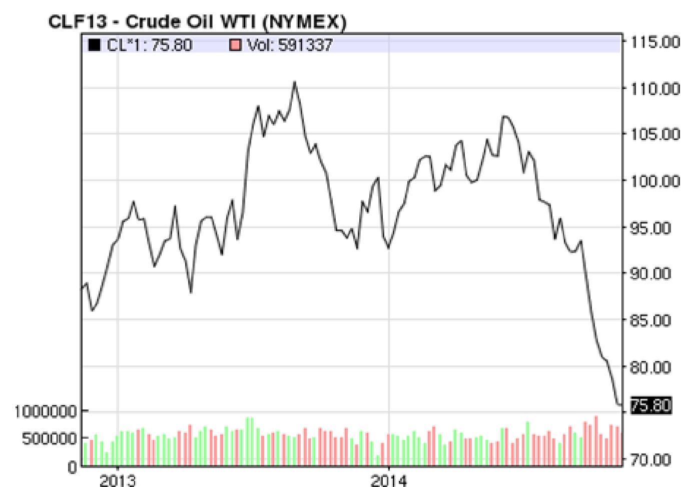
By Brian Langenberg, CFA

With two armed conflicts underway impacting economic performance in Eastern Europe and the Middle East, we continue our investment stance of "Buy on the Sound of Cannons — Selectively" — but readers of *Power Transmission Engineering* should not be sanguine.

Geopolitics is beginning to exert significant pressure on several end markets: I specifically refer to oil price. West Texas Intermediate or WTI has dropped from its $95-105 trading range in late spring to about $75 — about a (25%) drop despite two ongoing conflicts because of excess supply.

In our view this is not an accident. We call it "the Putin's Zipper Trade" because Vladimir has pretenses of greater Russian (Soviet?) glory, and at $110-oil, his budget balances and he struts around just the way the above "label" implies. In my view the Saudis are opting to attack him the best way possible — by cutting his government's revenue by over 20%. About 85% of Russian government revenues are driven by natural resources. Lower commodity price correlates to a stronger dollar and is very, very bad for his government and position. The counterargument is that Saudi Arabia is seeking to defend market share in the face of rising — but higher-cost — U.S. production, where higher-cost basins become less attractive, particularly oil sands, when oil drops below $80. We disagree.

WEST TEXAS INTERMEDIATE – LAST 2 YEARS
$ Per barrel



We will return shortly to how this hurts you.

WHAT MATTERS:

U.S. best growth spot. Non-residential construction, consumer durables (auto, housing) and gradually improving employment will offset weaker commodity-based demand.

Europe. Marginal hit (Nordics, resource-related parts of German economy) by conflict in Eastern Europe. Rest of continent still struggling with weak banking system, but that is nothing new.

Middle East. Buying weapons is in vogue (UTX), old construction projects (Otis) are getting finished, but new ones? Oil & Gas activity should remain strong even with production cuts because mature fields require more capital and the region is seeking to capture more of the value stream.

Brazil. Continues to get whacked. Exports are down (40%) the last two years already (weak China) on lower iron ore prices and volume. Petrobras story (oil) being hurt by lower oil price and emerging criminal charges/graft between Petrobras and people close to President Dilma Roussef. If that isn't enough pain for you, weakening Japanese Yen will further hurt construction equipment pricing in the region.

War matters, Ebola does not. Warfare in Eastern Europe and Iraq caused further order and revenue push- outs in 3Q (Flowserve, others). Improving defense after-market revenue likely continues.

Oil & Gas: U.S. midstream and downstream are bulletproof but *upstream spending will get tweaked downward.* Petrobras scandal may create further incremental uncertainty with your OE customers but the offset is Mexico is finally serious about investing in offshore exploration and production. 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.

The challenge isn't 2014 — its 2015! Upstream represents, by far, the biggest chunk of capital spending and while at least half will be aftermarket/production driven, a significant piece includes incremental exploration and, with oil below $80, marginal production. When wells lose money they get capped.

Potential second derivative weakness could occur in a broad range of end markets including construction equipment, land based power generation (small p not BIG P), and ancillary products and services. To be clear, we do not anticipate a steep decline, but would be amazed if energy sector capital spending does not decline in 2015. Other end markets....

Mining: *Still* awful — but hard to get worse; aftermarket is now stabilized.

Power Generation: U.S. power generation remains weak, owing to efficiency gains throughout the economy and lack of regulatory support for new (Wind) construction. Recent election results should have marginal impact on ability of administration to pressure coal sector (generation and the commodity itself), but there are bigger fights looming. Globally the industry looks good — including coal and gas.

Transportation Infrastructure: More pothole filling; no major infrastructure upgrade anytime soon. Immigration

COMPANY	TICKER	CAPEX (M) 2013 A	2014 E	% CHG
EQUIPMENT & SERVICES				
Schlumberger	SLB	3,943	3,800	(4%)
Halliburton	HAL	2,934	3,000	2%
Baker Hughes	BHI	2,100	2,000	(5%)
National Oilwell Varco, Inc.	NOV	669	600	(10%)
Weatherford Int'l Ltd.	WFT	1,575	1,275	(19%)
Transocean	RIG	2,238	2,600	16%
Seadrill	SDRL	4,699	4,500	(4%)
		18,158	**17,775**	(2%)

fight poisons well — not to mention ObamaCare — for everything that was pragmatically possible, including the corporate tax reform that could have brought funds back to reinvest.

Machinery: Capital is scared, translating into project push outs at E&C firms even as current production is up year over year. Agriculture is rolling over in the U.S. and Latin America. The Russia growth story is dead in the near term. U.S. truck build rolls along on replacement demand. Construction equipment orders have weakened, though utilization remains high in the U.S. while Europe is flattish and China declines. Non-residential activity and utilization supports a constructive view.

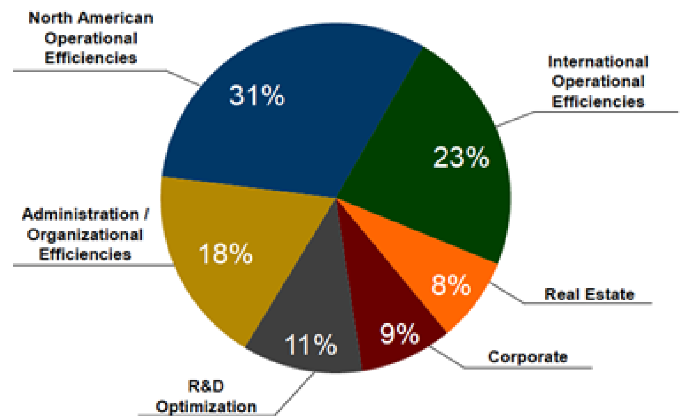
Consumer (auto, appliances): Old cars = continued U.S. strength. Auto-related end-markets will remain solid. U.S. residential recovery is on-track and will further support construction equipment demand.

Aerospace/Defense: Strong commercial build rates — coupled with two shooting wars and depleted U.S. inventories — argue for a continued recovery in aftermarket activity. Long-term we expect a U.S. defense recapitalization, but not before 2017 authorization, given the current Administration. We do think it happens no matter which party captures the White House in 2016, because anybody except the total infantile have woken up to realize you need to have both a) a foreign policy, and b) a big stick to back it up.

FOCUS COMPANIES: HALLIBURTON (HAL), BAKER HUGHES (BHI)

Precipitous drops in oil price often lead to M&A activity in an effort to drive out costs and protect or increase margin. To that end Halliburton recently announced an offer for industry rival Baker Hughes that would combine the #2 and #3 U.S.-based players. Diving into the capital spending data earlier we note that combined expected capex is about $5 billion in 2014.

The merger plan calls for $2 billion in annual cost synergies. Experience tells us that large deals hurt capital spending in the near-term (uncertainty, distraction of people worrying about their jobs), and post deal (paying for the merger through greater efficiencies and elimination of overlapping functions, people and assets).



Using their charts, about $600M (31%) relates to U.S. operational efficiencies, but also $220 million of R&D optimization.

Baker Hughes related projects carry higher risk. In reality there are no mergers — only acquisitions. Post-deal BHI shareholders will own 36% of the company. If two projects are marginal, the Halliburton project is more likely to win. You will want to think about this down to the ***Basin*** level.

Given both lower oil price and this merger, this is a good time to really focus on which Basins, OEMs and equipment service organizations your revenue stream is tied to in the Energy sector. **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*.