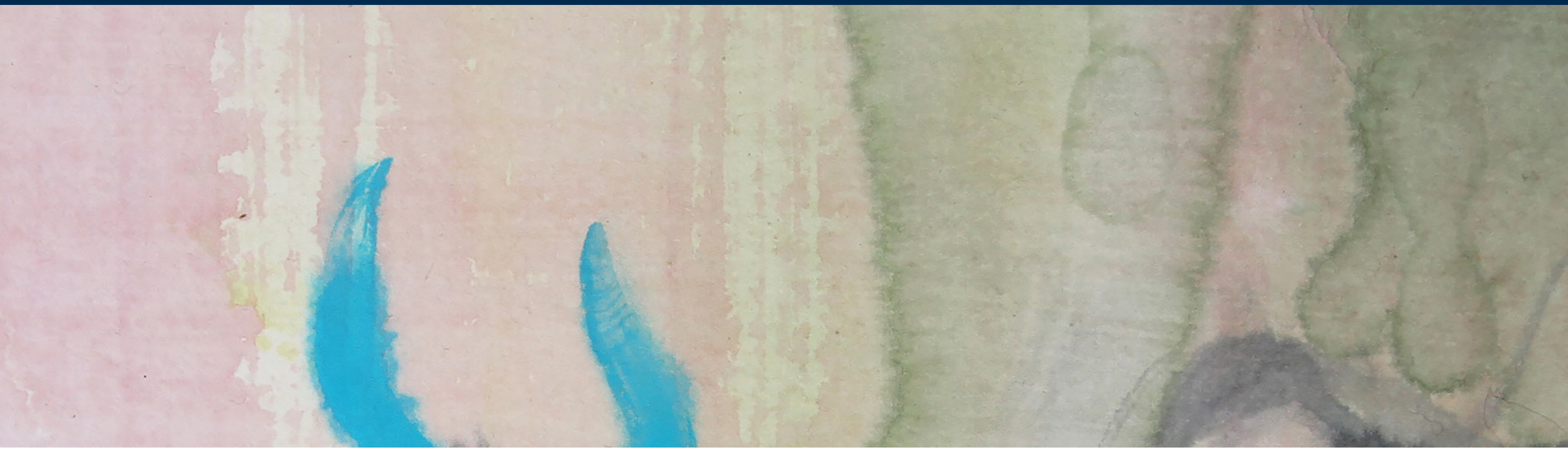

UPBEAT IN AMERICA'S INDUSTRIAL HEARTLAND

Article

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US manufacturing is often the focus of cataclysmic forecasts. The environment may have been, and is likely to continue to be, very challenging, but that is not to say the US lacks manufacturing leadership and world-beating industrial innovation. To paraphrase Mark Twain, reports of the sector's complete eradication seem exaggerated. Walter Scott Investment Managers Jamie Zegleman and Paul Loudon travelled to its heartland, the US Midwest, to judge for themselves.

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There is no doubt that times have been tough for the US manufacturing sector. Globalisation has taken its toll, once-proud industrial cities have fallen into decline and many firms have shrunk substantially or gone out of business altogether. Restructuring and downsizing in an attempt to regain global competitiveness have been painful processes. The percentage of American GDP attributable to manufacturing has halved since 1970.

In the past few years, however, there has been talk of a manufacturing renaissance and a palpable shift in sentiment across the sector. There has been rising employment in the sector since 2010, helped by rising labour costs in China and the health of the US economy.

Reality lies somewhere in the middle of this bust or boom. The sector undoubtedly continues to face material pressures, not least from international competition, but equally, there are grounds for confidence that the US spirit of entrepreneurship and industrial innovation has endured. The kinds of companies that we look for, with a clear competitive moat and a well-articulated and financed vision, are still to be found. It was with that confidence that we toured the US Midwest in late autumn last year.

The purpose of the trip was to see for ourselves how companies are faring and what they feel about the future. Our trip was planned in and around three cities – Minneapolis-Saint Paul, Milwaukee and Chicago – and we spoke to 30 firms. We met some at an industrial conference in Chicago and visited others on site so we could see their operations first-hand.

Some of the companies were very familiar, some were companies we have followed for some time but not yet invested in and others were new research ideas. In line with our strategy of seeking out best-in-class investments capable of delivering long-term, sustainable returns, the common link was that all of them had strong financial metrics and operated in sectors with growth potential.

If it is possible to make generalisations and summarise our conversations, these firms seemed fairly sanguine about the future. While acknowledging trade tensions with China and an uncertain economic outlook, the principle concerns were a shortage of skilled labour and rising inflation, particularly relating to haulage and certain raw materials.

Of all the companies that we met during the trip, five are worth highlighting, all standing out for different reasons.

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We met with an industrial product distributor that provides its customers with access to tens of millions of industrial products – from fasteners to hard hats to welding tools to duct tape. Its customers vary in size from GE to one-man garages and its products are sold from thousands of local stores. On first glance this might not seem the most exciting of businesses, but the company’s wide offering and its service has underpinned its success.

The company prides itself on developing and maintaining strong customer relationships. Over recent years, the business has moved to installing vending machines and even entire stores within customers’ own sites, in a bid to develop even closer ties. Deeper relationships enable the company to adapt more quickly to a customer’s needs, using that additional knowledge to deliver the right amount of goods and introduce the breadth of products available so that the customer gets exactly what it needs. Financially, it is a win:win for the customer and the company.

Another meeting was with a company at the other end of the industrial technology scale but similar in the sense that it works closely with its customers, reducing costs, improving efficiency and helping to maintain a competitive advantage. The business specialises in highly sophisticated cameras that are used to automate four key parts of the manufacturing process. First, they inspect goods on the production line to ensure they are of sufficiently high quality. Second, they identify products so factory owners know exactly where they are at every stage of the workflow process. Third, they guide robots. And fourth, they gauge the size and dimensions of different products and equipment.

The company is world leader in this field and spends around 14% of its annual sales on research and development. It appears to us that this is money well spent. The company is improving its products, creating new functionalities, moving into new areas and winning new business. As an example, the logistics industry has recently become a notable growth opportunity. Using similar identification technologies to those used in manufacturing, retailers and major e-commerce companies now use the company’s technology to track packages in their distribution systems.

Another company that we met makes fluid management systems, including industrial paint sprayers and equipment used to inject foam insulation into cavity walls. Struck by its impressive financials, we were keen to learn more by going to one of its factories in Rogers, Minnesota.

It was a fascinating visit. Watching futuristic films and reading glossy business magazines, it is easy to fall into the trap of thinking all factories are now pristine, automated and eerily quiet. This was a factory with inventory stacked up in piles, lots of noise and many workers doing relatively manual labour.

Here was a high-quality company operating in one of the most sophisticated economies in the world and there appeared to be plenty of scope for further automation and efficiency.

Beneath the technological fanfare and accompanying tales of doom for human labour, it was a reminder that adaptability is what counts. For traditional manufacturers weighing up investment and returns, and future growth, incremental change will very often be the right approach. The company was founded in 1926 and is a world leader in its field. Its processes have been honed over decades. Its approach to Industry 4.0 is slow, steady and sensible. Evolution rather than revolution.

In contrast we met with another company founded just 20 years ago. Since then it has grown to become a world leader in the swift production of customised prototypes. One of our colleagues met the firm at a conference last year and was so impressed with its model that she suggested we look at the company on our Midwest trip.

We visited the company's operations in Maple Plain, Minnesota. Almost every aspect of the business is digitised and automated. These are the factories of the future. The company's USP is making small batches of customised products – essentially prototypes – very fast: sometimes in less than 24 hours. It does this extremely well, it has been highly successful, and the site visit was fascinating. But we need many elements to stack up before we dig deeper into an investment idea. Given the short lead-time of orders – the company barely knows what it will make in its factories next week, let alone further out – the business lacks visibility and is also exposed to cyclical trends outside its control.

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The final example from our trip is a company that distributes spare parts for the aerospace industry. Many directors we meet spend most of the time talking about growth strategies, operating margins, forecasts and such like. In contrast, the passion within founder-led companies like this one is often tangible. The CEO spent almost our entire meeting talking about the company's culture – making employees feel like owners, through the pension plan and other incentives, and inspiring them to behave like entrepreneurs. His focus on cash generation as a core metric also chimed very well with us and our approach to investment.

This was a trip that gave us real food for thought. Yes, US manufacturers have been under pressure for decades, but the survivors, particularly the ones that we met, are genuinely world-class.

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