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INDUSTRIAL-STRENGTH CULTURE IN THE MIDWEST

FIRST PUBLISHED FEBRUARY 2023



Good news for the US manufacturing industry had been in short supply since well before the Covid-19 pandemic brought the world to a standstill. Thanks to the US government's \$1.2 trillion infrastructure package and \$200 billion five-year investment in semiconductor chips, as well as the trend in reshoring, there have been some glimmers of hope amidst increased levels of economic uncertainty.



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With all of this in mind, at the end of 2022, we spent two weeks meeting with 20 companies across “America’s heartland” in the Midwest. Long synonymous with industrial manufacturing, the region is home to some of the country’s most impressive businesses, even if they may not be household names. What’s notable about many of them is how they’ve not only survived, but indeed thrived, during the years when globalisation hit many domestic players hard.

Based on the years that we’ve spent meeting with and investing in Midwestern companies, we believe that much of this success is down to their unique and individual cultures. This latest trip only confirmed our thinking, with some common threads evident across businesses.

“Several of the companies we spoke to have been around for more than 100 years”

The most striking feature of our discussions was the strong sense of culture at these companies. There is real pride in their businesses and products, with a desire to protect what has made them successful. The humility amongst management and employees stands in stark contrast with some of our meetings with Silicon Valley types. Several of the companies we spoke to have been around for more than 100 years, with the “youngest” (Idex) still 33 years old. Nearly all have long-tenured management, employees and customer bases.

One great example of this is Badger Meter, which manufactures and sells water meters, communication devices and software to water utilities. It has had only six CEOs in its 120-year history, has employees who’ve worked there long enough to merit a quarter-century club, and prides itself on having customer relationships that exceed 50 years.

Cintas is another business with impressive culture credentials. Established in 1929 by two out-of-work circus performers looking to make money during the Great Depression, they collected old, used, rags from factories, laundered them and sold them back. It evolved into a laundry services business, rental workwear service and now also provides uniforms and other cleaning-related supplies.

“Across these businesses, there is a clear ‘promote from within’ mentality”

Key to Cintas’s success has been its guiding principles for all ‘employee-partners’, which were set out by the founder, Richard Farmer, and continue to be a core reference for all in the business. There are core phrases – “honesty and integrity in everything they do”, “competitive urgency”, “positive discontent” and “work shoulder to shoulder”. It may not be rocket science but with market-leading employee turnover of just 15%, Cintas is clearly doing something right.

Across these businesses, there is a clear ‘promote from within’ mentality, encouraging workers to invest in their careers at one firm. Many senior managers had worked across a range of divisions across different geographies so really understand the businesses they’re now leading. In contrast to so many other, younger companies, there is a genuine authenticity to the handbooks written by many of the founders, outlining their company’s values.

Fastenal, which distributes industrial and construction supplies, is a business we know well and one where ‘promote from within’ is key to its successful model. CEO Dan Florness has been at the company for 26 years, in his current role for seven of those.

Furthermore, these types of companies tend to be conservatively run with strong balance sheets, meaning they

weren’t forced to lay off staff during the pandemic. They have subsequently reaped the benefits of a strong and stable workforce, taking market share and codifying their company values.

“They... tend to be big players in very specialised markets”

In understanding why they have thrived for so long, a strong culture is certainly important but we also identified three consistent trends underpinned by the companies’ ethos. They are typically niche businesses, highly decentralised and increasingly automated.

Whilst keeping a firm grip on what makes them special, they also tend to be big players in very specialised markets, making critical products used in customers’ manufacturing processes. These markets aren’t big enough, or interesting enough, for larger players to contemplate entering. Typically, the products are a small part of the customers’ product cost, meaning that they’re willing to pay up for quality, resulting in strong pricing power. Given the crucial nature that these parts play, the customer would have to be very confident to switch to a competitor, creating a robust barrier to entry.

A company that specialises in highly engineered equipment to pump, meter, mix and dispense spray fluid materials, Graco, is a prime example of this approach. Its equipment is used in customers’ essential applications e.g. the sprayers for OEMs’ car finish paint. If customers deem their products to be mission critical, and if Graco can demonstrate its superiority in durability, quality and ability to increase line speed, it can charge a premium price. The benefit of Graco’s installed base means that, once embedded, customers are unlikely to switch out due to the potential risk.

Many of these industrials also have highly decentralised business models.

Employees are encouraged to think and act like owners, with their own responsibilities and accountability. Being closest to the customers, they are deemed to be in the best position to make capital allocation decisions. Despite this high degree of empowerment, the companies have identifiable philosophies and key performance indicators that management track closely.

The management of Illinois Toolworks (ITW), which produces everything from fasteners and components to kitchen equipment and auto parts, is extremely proud of its 80:20 business model which allows business units to focus on 20% of its customers that generate 80% of the profits. There are no top-down targets and divisions collaborate with customers, ensuring that they make the right products that work for customers.

“Everyone is looking to drive costs out of the factory and investing accordingly”

Idex, whose product mix spans unglamorous manufacturing pumps

to high-end components used in laboratories, operates a highly decentralised model, where unit leaders are allowed to have ownership and accountability. It follows the same 80:20 model as ITW to ensure they're focused on their most profitable customers.

What was clear from our various meetings and tours was that, for US manufacturing companies to be truly competitive in a global market, there needs to be a high degree of automation. Everyone is looking to drive costs out of the factory and investing accordingly. Given labour cost inflation, there is a pressing need to keep the momentum on automation up. During our various factory visits, you were far more likely to see machine tool cutters, robotic arms and sensors than any form of human activity.

On our tour of Fastenal's warehouse, the investment in automation was impressive. From our discussions with management, there is clearly plenty more to come in terms of increasing efficiency both for their customers and for Fastenal.

As an aside, it's worth mentioning that the strong Midwest culture doesn't just

apply to industrials. Our visit to Brown-Forman coincided with the news that its JD Bonded Series had won Whiskey of the Year and the atmosphere was electric. You could feel the immense pride of employees throughout the building, indeed our lunch with the CFO was interrupted by whoops of celebration throughout!

Upon their return from the Midwest in late 2018, two of our Research colleagues concluded that “US manufacturers have been under pressure for decades but the survivors, particularly the ones we met, are genuinely world-class.” Despite a significant global pandemic and subsequent economic downturn, we came home impressed and assured that many of the companies with whom we met still have the strength through their long-held business models and philosophies to ensure that they can weather any current and future turbulence.

After the hiatus of the pandemic, we were once again reminded of the importance of our research trips, and the valuable opportunity they provide for us to meet with company management and employees on the ground.

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