PERKINS INVESTMENT MANAGEMENT

DO INDUSTRIALS STILL OFFER COMPELLING VALUE?

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Since 1980, Perkins Investment Management has approached value investing from a unique perspective. Using extensive bottom-up, fundamental research to identify high-quality, undervalued stock opportunities, we conduct rigorous downside analysis on each prospective investment before focusing on upside potential. Our research team shares insights and opinions with our clients and partners through our Analyst Viewpoints series. In this edition, Perkins' Research Analyst Patrick Schott discusses the industrials sector with Client Portfolio Manager Valerie Newman. Schott explains how leaner, more efficient manufacturing firms continue to offer selective valuation opportunities for investors.

Q: Investors have experienced quite a roller-coaster ride in the equity markets over the past several years. How has the industrials sector fared during this period?

Patrick Schott: In the last few years, investors have seen some of the most exuberant and bearish equity markets in the better part of two decades. We've gone from global expansion with great earnings and momentum highs in 2007 to the depths of economic recession in 2008 and the beginning of 2009. And then in March 2009, stocks once again began a spectacular run.

Industrials certainly weren't immune to these extreme market movements. As with other economic-sensitive stocks, these companies have faced basically everything from the best of times to the worst of times. While the sector underperformed the broader stock market during the depths of the recession, manufacturing firms have significantly outperformed during the rebound. Throughout this period, we have found a number of compelling value opportunities, although we've maintained a conservative stance on the sector.

These firms cover an eclectic group of businesses – everything from machinery, multi-industry and waste management companies to automobile, aerospace and defense firms. Looking back at the history of these industries, if you had picked up a business periodical in the 1980s you would have read about the death of American manufacturing. The Japanese and Europeans dominated the landscape, and investors were greatly concerned about the economic health of U.S. industrials.

Fast forward to the present, and many of these firms now represent the leanest, strongest operations in the marketplace, with some of the best manufacturing practices worldwide. By implementing process management models such as Six Sigma, lean manufacturing and just-in-time production, these companies

Key Points

- U.S. industrials now represent some of the leanest, strongest operations in the world
- Our focus has been on larger, multi-industry firms
- While we are generally fairly conservative on the sector, we believe there is value in selective, higher quality names

have gotten themselves into very strong financial health. In fact, we think industrial companies have on par some of the best balance sheets in the stock market, with very attractive cash levels. The margins that these companies have been able to produce throughout the recent economic upturn and downturn have been much better than expected.

When the worldwide economic picture began to rapidly decline, these companies quickly shut down factories, depleted inventories and generated substantial free cash. As a result, many have been able to pull out of this recession much quicker than anticipated, showing real bottom-line strength.

Q: Will manufacturing firms begin to staff up again, given the growing number of economic signals that the worst of the recession may be over?

Patrick Schott: These companies have benefited significantly from productivity advancements over the past 10-20 years. Most should be able to handle roughly 10-15% volume increases before they need to start hiring additional employees. Also, many of the structural changes they've introduced are permanent in nature, such as moving to lower-cost facilities in other states or moving production overseas. As a result, we don't expect industrial companies to start making meaningful staff increases any time soon.

It is a bit of a chicken-or-egg problem for the U.S. economy. Without significantly higher sales demand, firms are unlikely to increase staff, and until the employment picture improves, spending will most likely remain at levels firms can support with their current staffing resources.

In general, Perkins is very skeptical that unemployment rates will start to come down quickly. The latest jobs report showed 29,000 manufacturing jobs added to the U.S. economy in May, with approximately 126,000 added so far this year. Unfortunately, these figures probably don't represent brand new employee growth. Instead, many of those positions were most likely people brought back in who were laid-off temporarily or part-time employees who were able to increase their hourly workweeks.

Q: As these companies have become more global, are there other macro variables that are influencing the sector, such as a weak dollar?

Patrick Schott: At Perkins, we are very much bottom-up stock pickers and don't focus too heavily on macro forecasts. That being said, we generally see an equal balance between positive and negative factors in the overall industrials sector.

On the positive side, there is a lot of cash on corporate balance sheets, which is good for these firms' financial health and for their ability to reinvest and grow their businesses. These firms are also stronger from an operational standpoint. As I mentioned earlier, much of the restructuring put into place by manufacturing companies appears to be permanent in nature. Consequently, the trough earnings power for many of these firms has been higher than we would have previously anticipated.

Going into the recent downturn, we wanted to assess likely downside exposure by analysing how different industrials performed during past recessions, based on their end markets. We thought the corporate recession of 2000-2003 represented a good comparison for a slowdown with manufacturers targeting other businesses. We also analysed the 1990-1991 recession as a proxy for what might be expected from weaker spending to consumer-oriented industrial firms.

In reality, companies in the sector restructured so swiftly that our estimates proved to be too conservative on both fronts. It looks like 2010 margins will bottom out about 100 basis points above the 2000-2003 recession and almost 300 basis points above the 1990-1991 recession.

On the negative side, we are concerned with what is happening in Europe right now. Even outside the specific situation in Greece, weakness in the euro and strength in the dollar hurts most of these companies, because many have become more international in nature. These currency movements have put pressure on some of our earnings estimates, making us a little more cautious on the sector's downside risk.

A related problem is that global demand is somewhat unbalanced right now. Asia, particularly China and Korea, is incredibly strong, with some companies reporting first quarter revenue numbers up 30-40% in their Asian operations. That's very healthy for companies with significant Asia exposure. The U.S., however, is still muddling along with only slightly positive rates, and Europe is just beginning to peek its head above water.

We are also concerned about raw material prices. So far this year, the copper, oil and steel markets have experienced some rather strong volatility. While pricing levels have been held in line, with capacity utilisation so low we are somewhat nervous about whether or not this pricing discipline will continue.

If the euro normalizes and commodity pricing remains disciplined, we think the positives for the sector tend to outweigh the negatives. With this in mind, we have continued to look for companies with strong balance sheets and solid operating performance.

Q: Where is Perkins finding value in the sector today?

Patrick Schott: Looking back just 18 months ago, the entire global economy seemed to be moving to the precipice of collapse. Strong fiscal monetary stimulus worldwide helped avert that crisis and prompted a very fast acceleration out of the decline. In fact, it looks like U.S. GDP will recapture its 2008 peak sometime during first or second quarter 2010. With this rebound, investors have rotated into highly levered, highly cyclical names, and these stocks have had incredible outperformance over the past year.

Perkins follows a very strict investment process. First and foremost, our focus is on capital preservation and downside risk exposure. We then consider upside potential. This disciplined approach closely examines balance sheet strength, with an emphasis on underleveraged firms with stable free cash flow generation.

Applying this methodology to the industrials sector has focused us on best-of-breed companies from balance sheet, operational and end market standpoints. We aren't looking for astronomical recovery earnings with these firms and instead are more interested in companies with strong free cash flow and well-diversified end markets across multiple geographies. In many cases, this approach has led us to larger, multi-industry names like Tyco (TYC), United Technologies (UTX), 3M (MMM) and Illinois Tool Works (ITW).

This process also helps identify areas to avoid because we aren't comfortable with the downside exposure. For example, we are generally uncomfortable with many of the automotive industry's macro dynamics. These types of concentrated businesses can have weaker balance sheets and are often subject to boom-bust cycles that are problematic in quantifying downside risk.

During the mid-2000s, U.S. consumers were buying 16-17 million cars per year, but when the economy went into recession sales fell to just eight million. This is a business model with high overhead and significant manufacturing costs, and unit sales dropped by nearly 50%! As a result, there have been only a few automobile-related stocks that we thought made sense from a valuation perspective throughout the market decline.

Q: Are there particular industries offering more opportunities within smaller-sized companies?

Patrick Schott: We have found opportunities across the market-cap spectrum in the engineering and construction industry, which is actually a very diversified segment in spite of its name. We are also fairly bullish on the oil and gas segments, where significant industry infrastructure still needs to be built. That is an area of the market we have been interested in for quite a long period of time.

With the Obama administration, there have also been opportunities with smaller companies that might benefit from increases in either government regulation or stimulus spending. For example, after the bridge collapse in Minneapolis, crumbling U.S. infrastructure could be one area where people will want to increase spending in the coming years. As a result, we have found firms that meet our rigid investment criteria with unique road, bridge or water infrastructure building capabilities in financially strong states, such as Sterling Construction (STRL) out of Texas and URS Corporation (URS), which operates across the U.S. and has exposure to government spending.

In addition, we like companies exposed to new regulations coming out of the Department of Defense and the Environmental Protection Agency. An example of this would be firms focused on decreasing the amount of carbon being released into the atmosphere or supporting environmental cleanup, such as Jacobs Engineering Group (JEC).

The engineering and construction space is particularly attractive because it plays on several different secular global themes that are somewhat less economically exposed. Our focus in this area has been on companies that we think have the strongest operating models, with solid balance sheets and attractive risk/reward characteristics.

Q: How do you think the sector will evolve over the next few years?

Patrick Schott: It will be interesting to see how industrial stocks evolve. Overall, we are fairly conservative on the sector and are focusing on high-quality firms. Our investment process is built around identifying potential downside risk exposure, and we expect the capital expenditure and working capital cycles to be longer than most people anticipate.

Many companies have generated cash by reducing capital expenditures and closely monitoring working capital. As a result, balance sheets have gotten stronger because firms have been less prone to spend on new plants or new production lines within existing factories.

But based on the extent these companies rely on generating revenues through consumer or other firms' capital spending, we think that revenue growth will be slower than anticipated by investors expecting normalized earnings power by 2012 or 2013. Traditionally, a corporate business cycle might be 8-10 years, and normalized earnings in 2012 or 2013 would put us at only a six-year timeframe.

The market rebound has driven a lot of upward movement in industrial stocks, and we are paying close attention to several structural issues at work within the sector. For example, debt-to-capital ratios for many of these companies during the mid-2000s were somewhere in the 30-40% range. Coming out of 2009, these ratios were in the 10-15% range. This has placed some companies in very good positions to keep their dividends strong, buy back stock or look for merger and acquisition opportunities.

Overall, we think we've found solid value potential within the sector, and are selectively adding where we think the valuations make sense to us right now. Lower-quality stocks have dominated the market run-up, but we expect the higher-quality names to be the sector's ultimate long-term winners.

About the Featured Analyst

Patrick Schott

Patrick Schott joined Perkins Investment Management LLC (Perkins) as a research analyst covering the industrial and manufacturing industries in January 2004. Prior to joining Perkins, he was an analyst at Strong Capital Management covering the financial, consumer cyclical, industrial and manufacturing industries for the small and mid cap value team during his six and a half years at the firm. Mr. Schott received his bachelor of science degree in business with a concentration in finance from the University of Minnesota, Twin Cities, where he graduated with high distinction. He received his MBA, with concentrations in finance and accounting, from the University of Chicago's Graduate School of Business, where he graduated with high honors. Mr. Schott has 13 years of financial industry experience.

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