ALGER

PODCAST TRANSCRIPT

Industrials Stage a Comeback

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"All of our companies are talking about inflation. But we believe investors will see this type of cyclical-driven inflation start to cool off over the next six to 12 months." Alger Senior Analyst Andrew Gustin explains why the industrials sector is now experiencing a significant resurgence.

ALEX BERNSTEIN: Hello, I'm Alex Bernstein and you're listening to the Alger Podcast, Investing in Growth and Change. The last time I talked to Alger Senior Analyst Andrew Gustin was in May of last 2020. At that time, the long-term impact of COVID on entire sectors was still extremely unclear. And Andrew's sector, Industrials, had been hit particularly hard. Now, more than a year later, we've seen some dramatic shifts in this sector. Here to give me an update is Andrew Gustin. Andrew, thanks for joining me this afternoon.

ANDREW GUSTIN: Thanks, Alex.

ALEX: Andrew, I clearly remember the last time we recorded a podcast, you had described the first few months of 2020 as "humbling." Now that the economy is reopening, have things improved for industrials?

ANDREW: Yes. I mean certainly the outlook for industrials has improved dramatically, and a lot of businesses that were impacted severely are starting to recover and are even progressing quite far in terms of recovery. I mean commercial aerospace is a great example of a sector that got completely crushed by COVID initially and, with the progress on vaccinations in the U.S., we've seen a quite robust recovery unfold particularly in leisure travel domestically, and we think that as we move towards the fall, we're going to start to see business travel start to recover and we'll also start to see international travel recover. So, the outlook is certainly brightening.
It's also been interesting to see how there have been certain pockets that actually did fairly well during the COVID sort of stay-at-home period and we're kind of starting to see a shift there. For example, so many people were stuck at home, and they couldn't travel and they were spending lots of money on projects around their home, maybe investing in a pool or doing other home-related projects, painting projects, that kind of thing. That sort of category has been really on fire and we're starting to see and we're anticipating a bit of a shift in spending towards travel and more experiences.
I think beyond that in recent months, we've been spending a lot of time thinking about longer term structural changes. One key area of focus has been the energy transition, and there's so much policy support and interest in decarbonizing and meeting global targets for emissions reductions. That is pushing us to look at lots of different companies that are participating in that energy transition in different ways and it's also helping us appreciate opportunities and challenges at our existing companies.
So, it's a really interesting time to be an industrials investor.

ALEX: Since you bring up the emissions reduction, I wanted to spend a minute talking about ESG. How are you taking ESG – or environmental, social, and governance – considerations into your process?

ANDREW: I would say that ESG is just becoming a much bigger part of the conversation with virtually all of our companies, and we do incorporate ESG into our investment process, and we do calls with our companies dedicated to ESG and we review the ESG scores that they've gotten from some of the ratings firms. We discuss those issues with the companies and make sure that we feel comfortable that they're doing enough to address whatever shortcomings they may have. And we're looking for companies that can be part of the solution as the world moves to decarbonize.

ALEX: And in terms of emissions reduction, how forward looking do you get? I mean, does gasoline ever go away?

ANDREW: Well, I mean it's going to be a pretty long transition, but we do think that electric vehicles (EVs) are going to grow much faster than the market appreciates. We think that EVs will be about 50 percent of global auto production in 2030 and so clearly that will have an impact on demand for gasoline but there's still going to be a lot of cars consuming gasoline that are on the road even if EVs represent 50 percent of new car production. So, over a very long period of time, we do expect gasoline demand to start to decline, but it's certainly going to be part of the ecosystem for many years.

ALEX: 2030 doesn't seem so far away. What do you think gets us to 50 percent by 2030?

ANDREW: It's been remarkable. The auto market and all the manufacturers have it seems like in the last six months really embraced EVs, and many of the major manufacturers, both American and European, are targeting basically phasing out internal combustion engine vehicles by in many cases 2035.

So, it's been a combination of the policy support for it as well as the competitiveness of electric vehicles relative to ICE vehicles. As the technology has gotten better, battery technology has enabled longer range and as we see infrastructure and charging stations deployed, it's going to really facilitate the production and uptake. I think more broadly the consumer demand for these vehicles is very much there and it seems like a very broadly felt social shift that people are embracing this move to reduce emissions and help keep planet Earth healthy for the next generation.

ALEX: Andrew, I wanted to switch over to the subject of inflation which, investors know, can have a significant impact on the Industrials sector. What do you think has been driving inflation and how has it been impacting the companies you follow?

ANDREW: Yes, it's definitely a huge focus for us these days. It does seem clear that we're in a more inflationary environment that may persist for a while. All of our companies seem to be talking about it. I think it's been driven by a number of different factors but if I can simplify a bit, you basically had a lot of production capacity and investment that was taken offline during the initial stages of COVID and then you had demand recover quickly and supply has been constrained and slower to catch up with demand. We've kind of seen this same pattern in a number of sectors, whether it's the oil field or petrochemicals or even in the freight transportation market where we've observed significantly higher cost for a lot of companies.

For example, in the air freight market, a huge portion of the air freight market was served by belly capacity on passenger aircraft. So, those planes haven't been flying, but freight still needs to move around by air and that has driven a huge surge in air freight rates. We've had ships backed up at our ports in part because we had COVID outbreaks and we've had restrictions limiting the dock workforce. People in some cases have preferred to stay at home. They haven't wanted to be exposed to COVID. Maybe they've also been receiving government support staying at home.

So, it's been hard to attract workers back, whether it's to factories or to drive trucks or to work in warehouses. Against a backdrop of recovering demand, that has really driven up transportation costs, and we've seen kind of the same pattern in many other markets, and in some cases, it's been exacerbated by weather or other events. For example, in the petrochemical market during this past winter with the winter storm that hit Texas and the Gulf Coast and knocked out a tremendous amount of production capacity, that took a lot of capacity out when you already had a fairly tight market and it drove the prices of propylene and other petrochemicals up significantly which has a huge impact on the consumers of those such as the paint companies.

So, it's been a really significant factor, and it's affecting basically all of our companies, and so we've been thinking about it in several ways. For a long time, we've really tried to focus on investing in companies that have strong pricing power so they can pass along these cost increases to their customers. Many of our companies are having to institute midyear price increases for the first time in a long time. So, we want to make sure that we are invested in companies that are supplying a product that is differentiated enough and that they have a strong enough market position that they can pass along that price increase and the customer still needs it and is still willing to pay for it. Maybe the product is relatively low cost in the grand scheme of whatever the downstream project is. So, a price increase is not going to throw off the economics of the transaction.

ANDREW (continued): So, we certainly want to make sure that our companies aren't getting squeezed too much by that inflation, that they can pass that on, and I think we've also tried to look at other beneficiaries of it, and we've been considering companies that are more on the upstream side for some of these materials that have inflated.

ALEX: Andrew, do you think that investors today are more open to inflation as simply part of the economy reopening?

ANDREW: Yes, and I do think it's widely appreciated that we've been in this inflationary environment. In fact, the stock prices of some of these commodity producers have gone up pretty dramatically. Actually, you're starting to see signs that at some point you'll see some of this cool off. You're starting to see a little bit more hawkish language out of the Fed. You're going to have certain things like some of those unemployment benefits that start to taper off in the fall. Increasingly we have people that have been vaccinated. People will go back to work. The congestion that the west coast ports that I referred to in that example, that's slowly getting better. In terms of the air freight example, you are going to start to see some of those international passenger aircraft added back. So, all that will help supply start to catch up with demand, and so, I think we will see some of the cyclical-driven inflation start to cool off in the next say six to 12 months. That's not to say that those commodity prices will go back to where they were, but things will start to cool off as supply catches back up.

I think as it relates to the longer term questions of inflation and how we would want to participate, I think we're looking for materials and commodities where there is more of a structural change in the long-term demand profile. So, it's not just a kind of transitory result of these supply disruptions and this COVID period where once we get back to normal, things will cool off a bit. So, for example, we were talking about the growth of electric vehicles. We think that EVs could be 50 percent of global auto production by 2030, which is up from only three percent in 2020. There's something like five times as much copper in an electric vehicle as there is in a traditional internal combustion engine vehicle.

So, while there's a short-term cyclical component to the inflation we've seen in copper, there's also a longer - term structural demand inflection that we're taking a hard look at understanding, and another example would be lithium, which is a key component in batteries that are used for EVs. I mean demand for lithium we think is going to increase by five to seven X between 2020 and 2030 as we're producing all of these electric vehicles. So that's going to require a significant amount of capacity additions and high lithium prices to incentivize those capacity additions.

So, as we look across some of these material and commodity companies, we're balancing the more shorter term cyclical-driven inflation with what we think could be a more long-term sustainable driver and trying to pick our spots and pick our winners based on that.

ALEX: Andrew, before we go, I just wanted to ask, now that things are opening back up, do you and your family have any plans for the summer, now that you can wear your masks a little less frequently?

ANDREW: We are going to take some time and go to northern Michigan, which is a special place for our family and my in-laws. So, our kids are looking forward to getting out to the lake and taking a little bit of time up there. So, we're excited. It's nice to be able to be out and about, and it really feels like there's a lot of optimism out there and it's certainly a lot happier than it was last summer.

ALEX: Andrew, thanks so much for talking with me this afternoon.

ANDREW: Thanks so much, Alex. It was great talking to you.

ALEX: And thank you for listening. For more of our latest insights, please visit www.alger.com.

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