Our Outlook for Industrial Stocks

Operating conditions in the industrial sector are showing signs of mending.

By John Kearney, CFA, Senior Equity Analyst

As we alluded to in our last quarterly update, many of the industrial names in our coverage universe sustained a punishing blow as economic conditions seemingly deteriorated by the day in late 2008 and early 2009. With heavy exposure to manufacturing and construction activity, disproportionately large downturns in these end markets hit the sector particularly hard and led to unprecedented profitability declines for many industrial firms in the first quarter. Though the economic pulse of the industrial sector is still subdued, we are starting to see faint signs of stabilization and recovery.

In May, the ISM Purchasing Manager Index (PMI) for manufacturing improved to 42.7 from 41.1 in April. While an index reading below 50 still implies that manufacturing is not expanding, a reading above 41.2 means the overall economy grew for the first time following seven straight months of contraction. More importantly, the new orders component of the ISM report increased above 50 to 51.1 in May, marking the first time orders expanded in 17 months. Anecdotally, we have heard a couple of industrial firms mention that they have started to see what looks like a bottom in North America and Asia-Pacific as order activity is picking up in aggregate. Additionally, both FedEx FDX and Illinois Tool Works ITW have recently commented that customer inventory de-stocking in North American appears to have ended. If these observations are accurate, it's reasonable to assume additional order activity and industrial manufacturing expansion is on the horizon.

Another positive economic reading in the quarter was the architecture billings index (ABI) which remained above 40 for the second straight month in April—the first time that has happened since August and September 2008. The ABI is a leading economic indicator of construction activity, as it reflects the nine- to 12-month lag time between architecture billings and construction spending. While the ABI still showed contracting architecture billing activity at a level under 50 in April, the new projects inquiry score of 56.8 showed growth in inquiries for the second month in a row. The increase in inquiries suggests commercial construction activity could start to improve over a period of several months. This complements increasing positive news out of the residential construction market where housing starts rose 17% in May, which was the third straight monthly increase in starts. If sustainable, even small improvements in commercial and residential construction activity could be a boon for many of the firms operating in the industrial sector.

Though increasingly encouraging economic news continued to filter in throughout the second quarter, the industrial sector is not out of the woods yet. Economic activity, while showing signs of improvement, still remains significantly depressed from normalized levels. Continued headwinds in both residential construction and commercial construction, coupled with a still anemic auto sector, will make for a tough slog over the near term for the vast majority of our industrial names. But if economic conditions continue to move in the current upward trajectory, the worst may be behind most of these firms.

Valuations by Industry

The accompanying table provides a valuation breakdown for each of the sub-sectors within our industrial universe.

Industrials Industry Valuations

Segment	Average Star Rating	Price/Fair Value*	P/FV Three Months Prior	Change (%)	Uncertainty** (%)
Aerospace & Defense	2.9	0.99	0.63	57	40.9
Airlines	3.01	0.95	0.69	38	98.9
Auto & Truck Manufacturing	3.13	0.81	0.58	40	76.1
Auto Parts Manufacturing	2.88	0.96	0.61	57	56.8
Diversified Industrials	4.2	0.73	0.62	18	1.1
Electronic Equipment	2.19	1.37	0.55	149	43.2
Farm & Construction Machinery	3.47	0.86	0.52	65	27.3
Homebuilding & Construction Products	3.72	0.7	0.48	46	79.5
Industrial Distribution	3	0.85	0.66	29	12.5
Industrial Products	3.25	0.91	0.58	57	44.3
Logistics	3.76	0.77	0.54	43	38.6
Marine Shipping	3.54	0.77	0.69	11	34.1
Packaging Products	3.51	0.85	0.54	57	34.1
Railroads	3.26	0.93	0.55	69	15.9
Retail - Automotive	3.31	0.88	0.63	40	45.5
Trucking	3.07	0.94	0.6	57	31.8

Data as of 06-12-09.
*Market-Weighted Harmonic Mean
**Ranks the industry's fair value uncertainty (most uncertain =100) based on the aggregate market-weighted uncertainty ratings of all industries under coverage.

It's no secret that the industrial sector experienced substantial value erosion in early 2009. In our previous market outlook, we stated that this value erosion was overdone and had created very attractive buying opportunities in the industrial space despite the industry's challenging near-term prospects. That assessment has already proven to have some merit behind it, as industry valuations over the last three months have converged much closer to our fair value estimates relative to the first quarter of 2009. The sector's average price/fair value ratio now stands at 89% versus the 62% level we calculated back in March. Most of this convergence is attributed to increased market valuations across the sector as opposed to reductions in our valuation assumptions. And although there has been a significant correction from valuations recorded earlier this year, the sector as a whole still appears undervalued based on our bottom-up analysis.

Our Top Industrial Picks

Top Industrial Sector Picks

Company	Star Rating	Fair Value Estimate (USD)	Economic Moat™	Fair Value Uncertainty	Price/ Fair Value
Rockwell Automation	★★★★★	47.00	Narrow	Medium	0.63
Black & Decker	★★★★★	58.00	Narrow	Medium	0.48
United Parcel Service	★★★★★	70.00	Wide	Medium	0.67
Caterpillar	★★★★★	51.00	Wide	Medium	0.63
Norfolk Southern	★★★★★	57.00	Narrow	Medium	0.64

Data as of 06-22-09.

Rockwell Automation ROK

Rockwell produces industrial process-control equipment designed to make factory floors more efficient. Given that factory spending is generally a function of overall economic conditions, Rockwell's business has taken a substantial hit lately. However, we believe manufacturers will continue to search for ways to wring out efficiency improvements in order to constrain costs in what could be a slower-growth environment over the next several years. Rockwell holds a prime position to benefit from this trend and appears attractively valued at today's price given the firm's upside potential.

Black & Decker BDK

The ability to develop innovative products, pursue strategic acquisitions, and build a strong brand has helped Black & Decker become one of the sharpest names in the power tool market. Declines in housing and consumer spending have delivered a blow to Black & Decker's business and are likely to weigh on the company's near-term performance. However, we believe that over the long term, Black & Decker's products, strong brand, and improved cost structure will generate excess returns for shareholders. With net debt/capital at a manageable 47% and a healthy cash balance of $325 million, we think the company can endure this downturn as it awaits an inevitable recovery in the housing market.

United Parcel Service UPS

United Parcel Service is the world's largest package delivery company. It has crafted a wide economic moat by assembling a dense integrated global shipping network that's unlikely to be matched by any but a few global players. The global economic downturn has put a strain on UPS' shipping volume in recent quarters and could continue to do so for several quarters to come. Over the long run, however, we believe overall global parcel shipping market expansion and consistent price increases will enable UPS to grow its bottom line at a healthy clip. Having generated an impressive 20%-plus return on invested capital during the past five years and free cash flow of 5%-11% of sales, we believe UPS' track record for creating shareholder value makes the company a particularly attractive investment at its current price.

Caterpillar CAT

Cat's near-term profitability prospects have certainly been constrained by a lower-demand environment, but we think this pause in growth will be temporary. Global initiatives aimed at boosting economic expansion through increased infrastructure spending will directly benefit Caterpillar as the world's leading construction equipment manufacturer. The filter-down effect of this spending will not be immediate, but the company should be able to weather the current downturn with a heightened level of resiliency in the interim. Furthermore, we think Cat will prosper once the global economic environment improves. We are also keen to the fact that the company offers a derivative play on inflation with its strong presence in the mining and petroleum markets.

Norfolk Southern NSC

Norfolk Southern is one of the best-run railroads in North America. The firm has one of the top operating ratios in the industry and produces around $1 billion of free cash per year—over 10% of revenue. Like all railroads, volumes have been in decline in recent quarters due to depressed economic activity. This has created an attractive buying opportunity, in our opinion, as the company maintains strong pricing power as demonstrated by its ability to raise prices every year over the last five years. As the economy recovers, we expect this pricing power to endure, which (when coupled with increasing volume) should propel Norfolk Southern's earnings power and produce attractive shareholder returns.

John Kearney, CFA, does not own shares in any of the securities mentioned above.