“Love comes from unexpected places”

A song from the 1977 album “Superman” by Barbra Streisand

Sustainable growth in cyclical industries

This paper challenges the commonly held assumption that strong and sustainable growth is most likely to be found in Consumer Staple stocks.

Russell Hogan, November 2017

DUNDAS GLOBAL INVESTORS

APOSTLE FUNDS MANAGEMENT

Dundas Partners was founded in 2010 to invest in the world's best companies. Our principles are independence in both thought and ownership and co-investment alongside our clients. Many US investors already invest for dividend and capital growth at home but it is still early days elsewhere. The opportunities outside the US are, if anything, greater and our five year track record highlights our ability to find these companies and deliver excess returns.

Overview

When discussing sustainable rising dividend investing, the assumption that many make is that the resulting portfolio will be replete with consumer products companies with stable patterns of demand. In fact, looking at the Consumer Staples sector over the past five years, dividend growth has compounded annually at just under 6%. This is a good number but one which is proving increasingly hard to sustain in the face of rising price competition and slower volume growth. Total returns from these stocks have been 10% per annum over the same period – close to the sum of the opening yield of 2.8% and the dividend growth. Investors prize the security that comes with these dividends, with the sector valued at 23x trailing twelve month earnings.

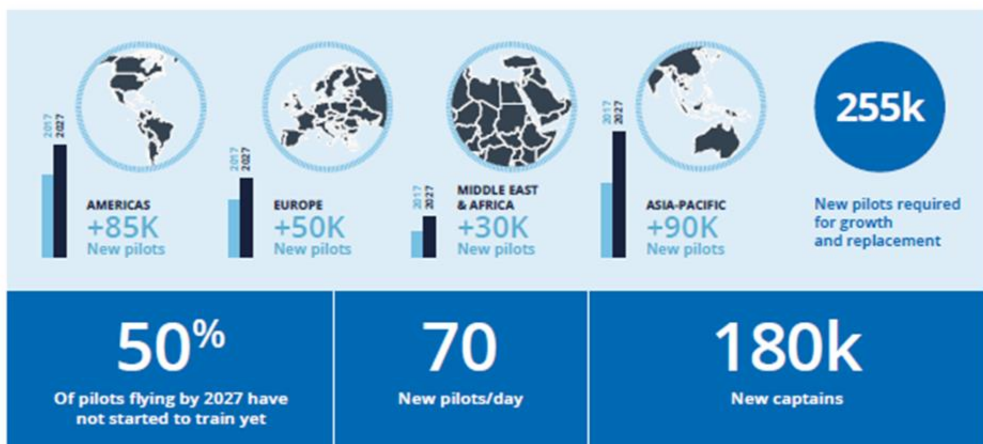
For Dundas, these stocks have seldom accounted for more than 15% of our portfolios. Why? We have found faster growing sustainable dividends elsewhere whilst paying, in most cases, a lower price for that growth. Industries that have higher, but less stable, growth rates have within them individual companies that are better able to protect themselves from excess supply or falls in demand.

Cyclical Industries

Aviation

Aviation has been one of the most cyclical industries over the past twenty years. At the time of writing over 100,000 holiday makers are having to be airlifted back to the UK due to the failure of another airline. How has this happened? The underlying growth of passenger miles travelled is fairly steady over time at around 4-5% per annum (considerably higher than global economic growth). The problem is supply. From placing an order to receiving your aircraft takes a minimum of around five years. In periods of economic downturn demand growth may falter for short periods while supply ordered all those years ago is still arriving. The result? Excess capacity, lower prices and higher costs. Put together, this has tipped airlines from healthy profits to very unhealthy losses. During this period few new aircraft are ordered, demand recovers in time and the stage is set for a shortage of capacity, higher prices and new orders to be triggered… and so the cycle goes on.

Pilot demand
Source: CAE



Our approach has been to avoid the airlines – although many have done very well in recent years thanks to lower fuel costs – and to focus instead on other companies in the supply chain. Canadian firm *CAE* is the world's leading manufacturer of professional flight simulators and is becoming one of the largest trainers of new and experienced pilots. In *CAE* we saw a firm tied to the ever growing ***stock*** of aircraft rather than the ***flow*** of new aircraft being delivered. In addition, regulations around the world are enforcing greater levels of ongoing pilot training, particularly in how to handle emergencies. Thankfully for the travelling public, this training is now undertaken almost exclusively in flight simulators.

CAE forecasts that the world will need 70 new pilots a day for the next ten years to fly the aircraft on order and to replace the natural outflow of those retiring. These growth drivers have enabled *CAE* to grow its dividend by 19% per annum over the past five years.

Industrial Gases

Within the Materials sector are a number of very cyclical industries. Aside from the commodity producing companies there are those in petrochemicals, agriculture and precious metals. In each case, the companies involved tend to be price takers and not price setters, leading to large swings in profitability.

The industrial gases companies serve many of these commodity producers but do so in a way that allows them to benefit from the long term positive trends in demand without the consequences of large variations in price.

For example, a new petrochemical facility requires a continuous supply of different gases including oxygen, nitrogen, helium and others in the process of refining oil and natural gas into industrial chemicals. To 'make' and deliver these gases a separate plant is required, which is a significant investment, and the five major industrial gases companies will tender. Contracts usually have a minimum volume agreed, allow for any input cost increases or decreases to be passed through and will have a long life to match the scale of the investment being made.

The net result for companies like ***Air Products*** and ***Air Liquide*** is a steady stream of rising cash flows linked to the volume growth in output, high levels of margin stability and good returns on capital. These are very capital intensive businesses with typically 60% of cash flows reinvested in new facilities or used to maintain existing ones. However, this creates a substantial barrier to new entrants. Dividend growth may not be spectacular given this high capex requirement but has averaged around 9% across the sector and is both stable and sustainable.

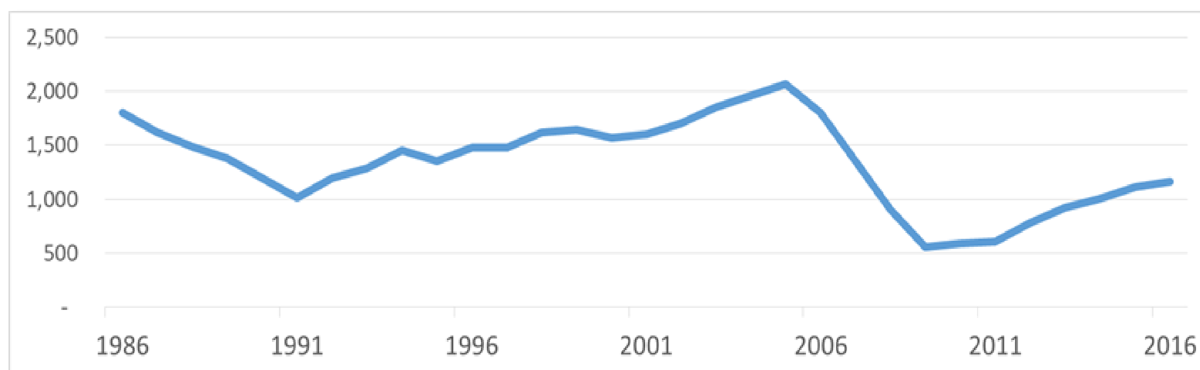
Air Liquide long term growth *Source: Air Liquide Investor Relations.*

Home refurbishment

House building is another industry with long lead times which, coupled with its link to mortgage rates, has made it a particularly cyclical industry. Companies operating within this sector are faced with decisions about land costs, the likelihood of obtaining planning permissions and therefore need to see a reasonably buoyant market before committing. The result is that a considerable amount of new supply can arrive at the same time – a particularly good example being the number of two bedroom apartments completed in London over the past three years. This supply glut has driven property and rental prices to their lowest level in five years.

While home refurbishment is somewhat linked to the same factors that impact new building, it is much more stable because, as in the case of CAE with pilots, it is tied to the total ***stock*** of housing rather than to the ***flow*** of new housing. Indeed, during more difficult economic times individuals and families are more likely to spend money on their existing home than take on a bigger mortgage to trade up.

Home refurbishment continued…



US housing starts over 20 years *Source: Bloomberg.*

Housing starts are a good measure of the cyclicality of new home building. Whilst population growth - i.e. demand - has been around 1% per annum in the US, the flow of new housing has been less steady. The chart above shows that new residential construction projects peaked at two million in 2005 before falling to half a million in 2009 following the global financial crisis then rebounding to one million in 2016.

An example of a portfolio holding whose growth prospects are linked more to the ***stock*** of housing is Swiss company ***Geberit***, which manufacturers high end bathroom supplies such as showers, toilets and washbasins. *Geberit* has managed its growth well and over the last ten years – including the global financial crisis – revenues have grown by 50% and, most importantly, profit margins have been steady at 20% supporting dividend growth of 10% per annum. While a proportion of its sales relates to new build homes and hotels, the majority is for remodelling existing homes.

Similarly, ***PPG*** is one of the largest paints and coatings companies in the world. It serves a variety of end markets including aviation (all aircraft require regular repainting), automotive and construction, which generates 45% of revenues from both the painting of new buildings and the maintenance of existing ones. *PPG* has grown modestly through annual volume increases and by acquiring and successfully integrating smaller firms in this fragmented industry. The stable quality of its business model and its ability to generate scale efficiencies have driven 10% earnings and 7% dividend growth per annum over the past five years.

How much to pay for this growth?

Despite managing to find stocks with sustainable growth patterns, there is always a risk of over paying for this growth. At Dundas we carefully monitor our holdings to detect early warning signs including weakening growth, margin and/or cash flow pressure, deteriorating balance sheets and, importantly, a run up in the valuation.

To use an example, we sold Japanese air conditioning manufacturer ***Daikin*** in early 2017**.** Over the period of ownership it had delivered revenue growth, margin improvements and double-digit dividend growth. At the start of the year the outlook for all of these metrics was weakening and having enjoyed fantastic returns and with the valuation now stretched, we decided to sell our holding.

A more recent example is US listed ***Air Products*** which we first invested in five years ago**.** We identified the sustainable growth characteristics of industrial gases highlighted earlier in this paper and our analysis highlighted that the stock was undervalued. Indeed, management has delivered huge cost savings, driving margin improvements and strong earnings and dividend growth despite a more muted industrial backdrop. The stock delivered a total return of 17.5% annualised in USD on dividend growth of 8% per annum, outperforming the broader market as well as its peer group. Major business restructuring is complete and the stock is now valued at or above its peer group and, in fact, higher than the Consumer Staples sector. *Air Liquide* offers the same growth prospects at a lower P/E multiple which led us to sell our position in the stock during August.

How do we find these companies? Bias free sifting for ideas

Over long periods, each industry group has become known for its inherent characteristics and it's no surprise that these become fixed in the minds of investors, who develop long term biases towards or against them. These biases can endure even as industries evolve and they tend to impact all companies within that industry group even when they shouldn't.

We actively seek to avoid biases in our research which is why we have a team of generalist researchers who are not attached to any one industry group. The team targets a particular industry group for around 8-10 weeks with the deliberate aim of looking for what has changed since our last encounter. That done, we move on to another industry, aiming to cover all of the 11 major industry groups every two to three years.

In undertaking these reviews we ***sift*** rather than ***screen***, meaning that we seek to look at as many stocks as we can in order to understand the competitive dynamics as well as identifying the winners and losers. This is in direct contrast to screening, which generally relies on predetermined criteria to reduce the many to the few, making it difficult to identify changes in industries while also perpetuating existing biases or preconceptions.

The benefits of looking at cyclical industries for rising dividends

We seek to invest in a wide variety of distinct – ideally unique – businesses across different industries with unconnected drivers of growth.

Certain industries have become popular amongst investors for the stability and growth of their dividends. As a result, these industries have seen the valuation of their businesses grow to the point where the cost of that stability and growth is high. This is particularly true in cases where growth is actually starting to fade but has not yet been reflected in the valuation.

We believe that a blended portfolio of different industries but, more importantly, drivers of ***growth***, can improve both diversification and the growth rate for a similar valuation. This is possible provided that we apply the same fundamental criteria to all of the stocks that we research and avoid biases for or against particular industry groups.

About the author

Russell Hogan
Managing Partner

Prior to joining Dundas, Russell spent 17 years at Aegon Asset Management, latterly in the role of CEO with responsibility for £33 billion across a range of equity and fixed income strategies.

Disclaimer

Dundas Partners LLP, which operates as Dundas Global Investors or Dundas, is exempt from the requirement to hold an AFSL under the Corporations Act 2001 in respect of financial services. Dundas is regulated by the FCA under UK laws, which differ from Australian laws.

This document is for information purposes only and does not constitute a recommendation to purchase or sell any fund, security or investment. If it prompts an interest in Dundas, please contact us for detailed information on our strategies and funds. It is not a substitute for a fund's prospectus or disclosure document. The material in this document addresses general investment matters only, not Dundas' specific strategies. Past investment performance is not a reliable indicator of future investment performance. You should be aware of the risks associated with investments in any fund, security or investment strategy.

© Dundas Partners LLP. November 2017.

DUNDAS GLOBAL INVESTORS

Dundas Global Investors
41 Northumberland Street
Edinburgh EH3 6JA
United Kingdom

P +44 131 556 2627

info@dundasglobal.com

www.dundasglobal.com

Apostle Funds Management Pty Limited
Level 28, 259 George Street
Sydney, NSW. 2000, Australia

P +612 8278 9554
F +612 9247 9976

karynw@apostlefm.com.au
gregj@apostlefm.com.au

www.apostlefm.com.au