

Global Industrial Outlook: Das (Human) Kapital

By Brian Langenberg, CFA

Second quarter financial results are yielding few surprises and confirming our views.

Economically we felt the U.S. would bounce back from an artificially depressed first quarter (weather) which has proven to be the case. Our prior installment “Frogs’ Legs, Bratwurst and the Bear” addressed three areas (see chart, above, right).

This month I will provide a current outlook update; provide key findings from a recent energy sector conference where I met with 16 management teams (within Oil & Gas); and go back to the “E” from our C.H.I.E.F. issues commentary back in February — i.e., Education and Employment.

Oil & Gas: We were fortunate to meet with the management teams of 16 major companies from offshore drillers like Transocean, to oilfield services provider Dresser-Rand. We also spoke directly to Exploration & Production companies. In a nutshell this is what we are communicating to our institutional investors and corporate relationships:

1. **Offshore is poised to accelerate in 2015.**
2. **Midstream (pipelines).** Strong expansion continues to get upstream energy supplies to market, supported by capital availability and approval of condensate shipments (recent approval to start exporting energy).
3. **Refineries.** Because of condensate export approvals (meaning lightly refined product) expect rising demand for new, modern LNG/LPG tankers and infrastructure.

Energy export is becoming a major opportunity for you. Get out in front of it. And we include the marine transport sector.

Mining. Still wretched. But the worst is over. Caterpillar mining revenue fell (37%) in 2Q with aftermarket almost

SUBJECT	WHAT WE SAID	WHAT HAPPENED	WHAT NOW
Current Outlook	Solid, 2Q bounce-back	Solid, 2Q bounce-back	Continued recovery; soft employment
Big Deal – Alstom	GE, Siemens — GE better buyer, one would get	GE wins with modified agreement w/French Govt.	GE — strengthened position in steam turbines, European service.
Geopolitics	Russia, Ukraine; China = Defense spending will rise globally over time.	Additions to the list: Israel vs. Hamas; Ukraine escalation	Europe will take its defense needs seriously; Poland, Scandinavia will move first.

flat. The U.S. market alone was down (28%). Dealer inventory declines are moderating and sales were up 6% vs. 1Q — but don’t expect a rapid upturn, given awful coal market conditions exacerbated by weak China demand for iron ore, coal and capital.

Power generation. More of same, near-term. Band-Aid sales (wind turbines) are strong, gas is advantaged in U.S. vs. coal and trending upward.

Transportation infrastructure. Nothing major, pre-election. Highway “Trust Fund” about as well-funded as a college student. No solution before ’16 elections and no political will to fund through higher gas taxes or other revenue. This is problematic from the standpoint of U.S. competitiveness.

Water & environmental. Municipal budgets and tax receipts are modestly improving. Recent concern about slower U.S. housing starts will prove overblown; prices are up, supply has declined. Municipals are already increasing purchases of things like garbage trucks.

Machinery. North American truck demand continues to accelerate — with Cummins raising its full-year heavy duty truck revenue guidance to +14% — from +11% (2Q was +10%). *Construction equipment demand will grow* despite a couple headwinds — namely China and lack of U.S. highway funding — owing to easy comparisons and improving, non-residential construction activity. *Agriculture will remain soft against comparisons* on lower farm cash receipts, but still at a healthy level.

Consumer (auto, appliances).

Global auto demand remains secularly positive, and U.S. sales will continue to benefit from a growing economy and aging fleet. Housing start sluggishness has raised concern, but we note that home prices are improving as inventory declines. Every reason to think conditions will continue to support sales of construction equipment.

Aerospace/Defense. Commercial air transport remains strong and the recent Farnborough air show yielded strong orders for Boeing, General Electric and United Technologies. Aftermarket activity remains robust. Defense-related declines have moderated and our secular view (more defense spend) has been fleshed out.

C.H.I.E.F. Issues Update

Back in February we spent time discussing the “C.H.I.E.F” issues impacting the current economic recovery and the long-term health of the U.S. economy.

- Corporate tax reform
- Housing
- Immigration
- Education and Employers
- Finance

Corporate tax reform. I actually think this gets done in 2015. There is bipartisan agreement and support. Scenarios against this would be Democrats retain majority and Harry Reid stonewalls. A Republican-led House and Senate could deliver a bill and probably get pragmatic Democrats to go along (they do exist).

Housing. The economy has strengthened enough to pull back on “quantita-

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tive easing,” but employment concerns will keep Federal Reserve Chairman Janet Yellen from hiking interest rates that could derail a housing recovery and employment growth. While inflation is a concern, we see real unemployment as being too high to drive broad wage hikes.

Immigration. Given the orchestrated border issue/political stunt, with its human toll, nothing happens in '14. Long-term, the 11 million people living here *are not leaving* and another 100,000 people are a rounding error. But this could now take a while. Democrats want additions to their voting bloc, corporations want access to “ready labor;” engineers, scientists, unskilled, and much of the U.S. population is saying, “Oh, and what about us?” Stay tuned. This is messy.

Education & Employment. Health care, education, and training; we address some moving parts shortly.

Finance. While the drag of increased regulation and compliance from Dodd-Frank continues to impact major banks, the availability of credit for large companies and large deals remains high. We've also seen improved access to capital for smaller companies.

Das (Human) Kapital

Just in case you missed it—which you did not—the economic statistics show continued growth, rising corporate profits and improving consumer confidence. After the near-depression experience of 2008–2009, this is to be expected. But it is not good enough. In addition to weak employment growth, health care costs continue to rise, labor policies create obstacles, and the middle class is struggling to maintain their “margin” between income and expenses.

Unfortunately, it affects your revenue, your profits, and your ability to find, train, and retain good people. But, being the great businessperson you are, there is always another way to skin a cat. Sometimes you get price — great! Oftentimes, you must find a way to do more with less or *get more for less*.

First, let's show how government does not help:

Health Care. I have a high-deductible family health insurance policy through Aetna. No extras like prescrip-

tion drug benefits, etc. I have health insurance simply to ensure emergency room access if we ever need it and to get some benefit from Aetna's supposed purchasing power on health care and medicines. In the last four years I have probably paid in about \$25,000 in premiums and collected zero in reimbursements. No worries—I would rather be healthy and spend less. What is disconcerting is that somehow, in the past three months, a prescription medicine I take, and which had been steadily

priced at \$220–\$230 per month for about four years, has ballooned to \$300 per month since ObamaCare more or less went into effect. I have no reason to believe the raw material costs went up by 20%. I believe I am being forced to subsidize a botched reform and Aetna has done *nothing* to represent my interests as their customer. I have told them as such.

What can you do about it? Near-term, very little. Implementation issues, enrollment shortfalls and litigation of a

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range of issues, plus an election year, mean air cover for insurance carriers to raise rates, play with exclusions, etc. I think, over time, that more cost-effective solutions can be devised to include a degree of “self-insurance” at the employer level; but large companies will tackle this first.

Education. A full year at the University of Illinois with tuition, books, room and board, and incidentals is now priced at \$30,000–35,000 per year for in-state. This happens because price rises to absorb all available government funding and student loans. But change is coming. The University of Indiana, now being led by former governor Mitch Daniels, is working on the theory that there was no need for a 75% increase in administrators, and is designing a 3-year degree based on *knowledge*—not just classroom hours.

Alert, Alert, Alert. Starbucks recently cut a deal with Arizona State University that portends a big opportunity for companies to attract, retain and reward employees—and also help the company. Besides goodwill and a concurrently announced price increase, Starbucks is seeking to improve employee retention. The online degree program at ASU is \$3,000–10,000 per year for an individual. Compare that to U of I on campus. Starbucks intends to deliver 15,000–21,000 students to ASU and pay for all or part of their school. Let’s assume they negotiated a 1/3 discount to \$2,000–7,000 per year. If Starbucks pays even half, it would cost them no more than \$3,500-per-head (<\$2/hour) and their employee/student can pay out of pocket and graduate with work experience and no debt. Everybody wins!

Can your 40-person shop get that same deal? Probably not. But why not have the AGMA negotiate a discount with a few “brand name” schools and technical colleges for all AGMA members, their employees *and the families of their employees*? Could this be a way to provide a valuable benefit without breaking the bank, and helping to offset health care cost pressures? Hmm.

My point is there are innovative paths to leverage purchasing power and negotiating capabilities that come with hard-earned experience to benefit your organization *and* your employees!



	PERCENT TOT.		CHANGE		REVENUE		
	COMPANY	REGION	YY	Q/Q	Act.	Prior Qtr	Prior Yr
CATERPILLAR							
Energy & Transportation	16%	38%	2%	9%	2,259	2,082	2,215
Construction Industries	17%	41%	21%	15%	2,402	2,092	1,989
Resource Industries	6%	15%	(28%)	19%	866	725	1,198
NORTH AMERICA	42%		6%	13%	5,881	5,219	5,526
Resource Industries	4%	19%	(41%)	5%	510	484	864
Energy & Transportation	7%	38%	(8%)	16%	1,040	894	1,128
Construction Industries	8%	41%	(1%)	(11%)	1,102	1,242	1,116
ASIA PACIFIC	19%		(14%)	1%	2,713	2,677	3,142
Energy & Transportation	10%	44%	4%	6%	1,406	1,329	1,352
Resource Industries	4%	16%	(41%)	(2%)	523	532	879
Construction Industries	8%	37%	14%	4%	1,192	1,144	1,044
EAME	23%		(3%)	3%	3,202	3,105	3,312
Resource Industries	2%	21%	(46%)	(15%)	342	402	630
Construction Industries	5%	45%	1%	21%	711	586	701
Energy & Transportation	3%	29%	(17%)	(0%)	470	471	568
LATIN AMERICA	11%		(16%)	5%	1,595	1,512	1,906

FOCUS COMPANY: CATERPILLAR (CAT)

We are revisiting Caterpillar because it is a) large and important; b) you care; and c) changing trends that warrant your attention. CAT generated strong financial results, despite revenue softness. Positives include continued North American demand in construction—which should continue—and signs that the mining debacle has passed its worst.

But we also detect difficulties. First—China is softening. Excavator demand has slowed and Cummins, a major supplier in China and to CAT, is calling for China excavator demand to fall (14%) for all of 2014. Further, China is showing no signs of increased appetite for iron ore and metallurgical coal, which puts a damper on mining and Australia.

Second, locomotive production is running flat out this year in front of higher emissions requirements, and the company is signaling clearly a sharp decline in 2015–2016.

Finally—the company is authorizing \$2.5 billion in share repurchase, signaling they have plenty of productive capacity.

So while things are not terrible, we sense overall demand upside is limited.

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