Research @ Citi Podcast Episode 65: You Can't Spell Industrials Without "AI"

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Anne Malone (00:02)

Hi everyone. Welcome to the Research @ Citi podcast. I'm Anne Malone, the North America Head of Equity Research at Citi. With me on the podcast today is Andy Kaplowitz, our Sector Head for Industrials at Citi. Andy covers the Multi-Industrial and E&C sectors.

Today we're going to have Andy provide his view on the potential effects of AI, major trends, developments to look forward in the sector, and insights into what you can expect. Andy, it is always good to have you.

Andrew Kaplowitz (00:28)

And thank you for having me.

Anne Malone (00:30)

So it's still early in '26, although it's been a very long winter. Tell us, what are the themes?

Andrew Kaplowitz (00:36)

It's definitely been a long winter, Anne. So I have actually several themes impacting Industrials. The lead theme is AI. And what I like to call it is, my companies are AI enablers. They're companies that are focused on power, they're companies that are focused on thermal management, they're companies that are focused on electrical. And all of these companies are experiencing significant growth.

Growth has been accelerating. There is a debate as to how much acceleration we're going to continue to have. There's always an ongoing debate around when peak spend might hit my companies.

For what it's worth, we think that peak spend is still probably years away. It's hard to know for sure about growth rates, but we think growth rates are going to stay strong for the companies that I mentioned in power, electrical, and thermal management for the foreseeable future. So that's one big theme that I think is really a megatrend that supports industrials.

Anne Malone (1:41)

And I think the challenge with peak spend is you only know when something's peaked as it starts to decline, right? We can agree upon that. Is that really a strong debate? Are there people who believe it's far sooner?

Andrew Kaplowitz (1:59)

Yeah, it's a good question because every day there's a question around hyperscaler spending in the technology space and how that might impact Industrials. And then we're in earning season now in Industrials, and we see some of our companies are reporting 200% growth in data-center capex funding … or should I say orders? And so when you see that kind of number, you get concerned that maybe it doesn't get better than that.

But at the same time, I would say almost every time so far, it's a quick bounce-back of both my stocks and also sentiment, because most of what we see out there suggests that hyperscalers and the greater AI customer market are still in the early going of spend and, of course, using AI over the long term.

Anne Malone (3:00)

But why don't you put some context around that? A number like 200% growth, what were you expecting?

Andrew Kaplowitz (03:07)

It's a good question. So one of my companies called Eaton, that company had reported 70% order of growth the quarter before in data centers and then recorded 200% growth. So we definitely thought that growth was going to be significant — probably similar, if not maybe slightly higher, than what we saw last quarter.

I often call how AI capex hits my companies as waves. And so this looked like another wave of spending, but 200% was definitely more than expected. Again, the good news, I think, is that most of my companies suggest that they're not going to sit there and tell us, “Well, we're going to have 200% forever.” But what they are going to say is, “We still have a very good pipeline of opportunity.” And that's what I hear across the board.

And I also hear that from my tech peers. A lot of my analyst tech peers, they have their own assumptions. We work with them very, very closely, and they've been talking about, for instance, a CAGR of almost 50% capex growth over the next several years for hyperscalers. And so even though there tends to be occasional scares, it seems like it's still up and to the right for a while.

Anne Malone (04:30)

So, two-pronged follow-up. What does that mean for what you see? And let's call it revenue and margin expansion. Where does that place the stocks now in terms of wherever you want to call it: on the cycle, on valuation? Like, how do we measure where the stocks are?

Andrew Kaplowitz (04:49)

Those are great questions. So I would say —

Anne Malone (04:53)

Ex-analyst, Andy. Come on.

Andrew Kaplowitz (04:54)

Of course, of course. So look. What it alludes to is that most of my companies are not going to grow 200% or anything close to it. They are going to be capacity-constrained, to a certain extent. And so I think what we have modeled or thought about for most of our companies is call it mid- to high teens, maybe 20% growth — revenue growth — on the high end per year. Because remember that none of my companies are 80% and are 100% data centers. The most that I have is a company who's 80% data centers. So obviously there's going to be different growth rates, ex-data centers.

But I would say, even if I think about the data-center vertical, we're not going to see that kind of growth because it is relatively capacity-constrained. But what that does mean is there are several companies in my space that could grow double digits in revenue, organic, over the next several years.

Now to your question on margins. Because this has been a pretty strong influx of orders pretty quickly, and a lot of my companies have had to increase capacity, that does lead to some friction in margin. Like normally you'd see very high incremental margins on this stuff because a lot of these large projects are relatively standardized for my companies.

A good example is HVAC. They are beneficiaries. Instead of five or 10 chillers for a hospital, you then make 100 chillers for a data center. And you can standardize that pretty well and get very good margins. But if you are increasing capacity at the same time, where let's say you hire a bunch of people before the data-center project actually ramps up in revenue, you can get some inefficiencies.

So the way we look at it is there's going to be margin expansion because of operating leverage. It may be a little bit less than what is possible, but it's still pretty strong. The average incremental margins in our space tend to be around 30%, maybe low 30s. I'd say in general, most of my companies are talking about into the 30s, if not a little bit higher, these days. And part of that is pretty good operating leverage.

Anne Malone (07:11)

When I hear “capacity-constrained,” that can be a concern, right? You could have a quarter or two where perhaps it doesn't land as you thought. What does worry you about what could get in the way of what seems like a unique opportunity and time in the space?

Andrew Kaplowitz (07:28)

Yeah, it's a great question. So I think that capacity worries me, that's why I talked about it. I think that tends to be transitory, though. When we see those kinds of things happen, they tend to be a couple quarters, maybe even a year where they slow down margin expansion —

Anne Malone (07:47)

But transitory because a smart management team can unlock it —

Andrew Kaplowitz (07:51)

— figures it out.

Anne Malone (07:52)

Figures it out.

Andrew Kaplowitz (0

Right. Exactly.

So again, to your point, you need a smart management team to manage this kind of ramp-up. So it can go wrong. But most of the time, a lot of my companies have smart management teams, and so they figure it out. There is some short-term inefficiency but then it gets better. And so that's a big concern. But I think, again, it's transitory.

The other big concern, obviously, is that AI capex growth permeates everything in Industrials. For instance, I mentioned power, I mentioned HVAC, I mentioned electrical. But there are even other offshoots. Like if you're building a lot of data centers, you need a lot of water. So it impacts water-infrastructure companies. It tends to lead to more commodity demand because a lot of the electrical stuff needs copper, as an example. So all of a sudden you see mining ramping up.

So what's interesting is that we — and I know we're going to talk about it — have, I think, a broader industrial rebound going on. But there are tentacles that come from the AI capex upturn that kind of overlay with the broader industrial upturn because it impacts so many other industrial markets.

So what I worry about sometimes is the volatility in my space can be very high when one of the hyperscalers says, “Oh, you know, maybe I should delay a couple of data centers, from spending on them." Or somebody worries about the debt structure of another hyperscaler. Those kind of things tend to impact not just my data-center-exposed names but some names that you would think aren't as data-center exposed, because, again, I think it is propping up a lot of Industrials.

Anne Malone (09:46)

Let's get back to that for a minute, but I can't help but say it: So all of these companies, are they in the right position to finance this growth as well? Do they have enough funding coming in at the right time, at the right price to do what they need to do to deliver?

Andrew Kaplowitz (10:04)

Yeah, it's a good question. So my industrial companies, they are relatively under-levered, actually, and so they're in quite good shape.

I mean, we've had an OK industrial environment for the last few years, but I would stress just OK. And what that's led to is, maybe, a little bit more limited M&A than you might normally see. I think that is ramping up, by the way, but a little bit more M&A. So, balance sheets are maybe a little bit more under-levered.

And I think there's also been a little bit more pausing on spending because we've had a pretty choppy economic and geopolitical environment for a while. And so that leaves some cash to spend. So I think that the interesting thing also about the last two years is that generally you're seeing my companies slowly but surely increasing their capex.

They're doing it to fund these capacity expansions we talked about. They're doing it to fund other things like increased automation spend, anything that can increase productivity and/or support some of these larger projects.

Anne Malone (11:18)

Let's double back a minute, though. Expectations, and let's put that in the form of valuations.

So where do you think most investors are thinking about where the stocks are vs. their expectations, and how are they valued? Because I assume that can add or deduct from volatility.

Andrew Kaplowitz (11:39)

Our stocks have generally enjoyed a broad rebound here, I think, over the last few months. Some of it is, again, generally the landscape we talked about in data-center capex looks good. But the other aspect to the rebound in my names is what I call broadening. And broadening is that the rest of the industrial economy — the economy outside of just data-center spend — is looking better.

And, you know, you can see that. I mean, if you look at the U.S. ISM, it has picked up a bit. You know, this was the first over-50 reading in January in the last year. You know, we have had head fakes before, but when we talk to our companies, they generally are talking about, again, modest but steady improvement.

And I think part of that, Anne, is that, again, for the last few years, it's been volatile just as an environment. And then companies have gotten a little bit more used to the volatility. But I also think that inventories in the global industrial channel got pretty low across most of my end markets because, again, nobody wants to hold inventory.

So if you have just a little bit of demand … semiconductors is another area where we're starting to see more spend, for example. So you'd have just a little bit of demand, you don't have any inventories, you see that reflected pretty quickly to my companies.

So now that gets your question of valuation. Our U.S. Multi-Industry does tend to trade at a modest premium to the market, which it is doing right now again. But it's not really trading much more than its normalized, modest premium. Now, you could say to me, “Well, Andrew, that's because tech trades at very high levels and the S&P is at 7,000....”

Anne Malone (13:47)

It's one big circle.

Andrew Kaplowitz (13:49)

That's part of it. But again, this is where I would say to you that I still am pretty positive about Industrials in the sense that our valuations are not outlandish, if the AI capex cycle lasts and this broadening is at least a little bit for real. You know, if we go back into the high 40s, as we've been stuck in, in the U.S. ISM for the last three years, then I think you're going to get a sell-off in our stocks.

But if you can stay kind of where we are, our companies, as we just talked about, have a lot of firepower on their balance sheets. They actually are experiencing good growth. It's a little bit more broader than it's been. And so we would say there's still opportunity in our space.

Anne Malone (14:35)

That U.S. ISM number, is there a risk? What's causing that? Is there a risk that it's all AI-related, yet we don't recognize that? Does that make any sense? That outside of AI is rising, but like you said, the tentacles run deep.

Andrew Kaplowitz (14:57)

Yeah, I mean, that's exactly what I'm saying. I'll give you another example: Construction markets seem like they've picked up pretty significantly.

Anne Malone (15:08)

And what are they constructing?

Andrew Kaplowitz (15:10)

Exactly. So there's a decent chance that most of it is data centers. But I would say there are other things going on, like reshoring.

If you talk to our Pharma/Bio analyst peers, they would tell you that there's incremental shoring or reshoring, whatever you want to call it, of Pharma/Bio facilities. And again, I mentioned semiconductors, another area where you're seeing more building on the ground here in the U.S. So I would say not all of that is about AI capex.

Anne Malone (15:48)

OK, so I want to get to our Miami topic, but I assume that's the administration, tariffs, etc. So I can see your point. It is not AI-related.

Andrew Kaplowitz (15:58)

And I think that's actually a really important point to make: You know, our administration is pushing “build in America.”

Anne Malone (16:07)

Yes.

Andrew Kaplowitz (16:08)

But I think there's a bigger thing going on here. It is deglobalization to a certain extent. I mean, I grew up as an industrial analyst in a period of globalization. But starting with the first Trump tariffs in 2018, I think companies started to say, “We need to build duplicate supply chains, close to where our customers are.” The pandemic exaggerated that, and the supply-chain issues after the pandemic. And then, of course, Trump tariffs 2.0.

So I think companies are now like, “Listen, who knows what's going to happen next? We've got to build closer to our customer.” And I do think we're seeing that across our companies. And that is, again, outside of the data-center thing.

And just one more thing, because you mentioned stimulus/fiscal bills. The OBBBA — the Big Beautiful Bill — is pretty supportive of spend here in the U.S. There are various tax deductions for companies: R&D, or bonus depreciation that can support spend here. And I think we're going to see a little bit more of that as we go forward.

Anne Malone (17:21)

A year ago, we were all in Miami together at Citi's Industrial Tech and Mobility Conference. And I do remember that was like Day Zero of talking about tariffs. That was the only topic there was.

So next week, we'll be back in Miami, Feb. 17 to 19 at this year's Mobility Conference. Can't believe AI won't be chief among the topics. I did check before we came on: The Weather Channel says that Miami will be mid-70s, where New York City will be 50s, which is going to seem balmy for us. Twenty-five-degree difference for you guys down there, good luck!

Outside of AI, what do you think we'll be pivoting to, and the topics at that conference?

Andrew Kaplowitz (18:04)

Well, we do expect very good weather down there, so hopefully that is good for attendance.

But outside of AI, again, the No. 1 topic is going to be whether this broadening is for real or not. And we expect our companies to be reasonably positive about broadening. But again, we've had head fakes before. So I would describe it as cautious optimism. We'll see what's going on.

I mentioned M&A briefly — it does seem like M&A has picked up a bit. And again, I think our companies have really good balance sheets. So where are they going to take this cash? What are they going to do with it? What are the types of acquisitions that they're looking at? I think that'll be important.

And then I think, ultimately, we talked a lot about AI spend, but we haven't talked about AI productivity. And I do think that's a topic that's going to really start to come out much more for our companies. I mean, we are hosting a panel with some of our big companies on AI productivity at the conference, because I think that's another enabler of stronger margin performance in my companies where we're just scratching the surface.

Anne Malone (19:12)

So that just hands up the baton from the initial build. Is there any debate, or is that all consensus, or is it we're trying to model how big the productivity gains could be and when? Like, what's the discussion?

Andrew Kaplowitz (19:26)

Yeah, it's a good question. I think there is a very healthy debate going on between, first of all, how much productivity we're going to get, and when. But then there's also a debate around for the companies who are not AI enablers. There's also a sort of winner's bucket and loser's bucket about the impacts of AI, right? It's like, “Who can be more productive with AI, and why?” But then, “Who might get disaggregated or disrupted by AI, and why?”

And so that question comes up to me fairly often. And I think our companies are going to try at this conference to put themselves in the AI Winner basket vs. the AI Loser basket, as you would expect. And again, I think it's early days, so the debate will continue.

Anne Malone (20:13)

Anything else we should be looking for? Milestones, guideposts — whatever word you want to put on it — either regulatory-wise, legal, rates? Anything like that we should be making sure we touch upon before we wrap up?

Andrew Kaplowitz (20:28)

I mean, it's a very interesting year in the sense that it is a midterm election year. We'll see what the administration does about trying to make everything look good in terms of the economy ahead of the elections. And there's been questions on housing affordability. So, can you do anything there? Because obviously I cover names that are exposed to residential-construction stocks.

I would say we have a new Fed chair coming in, the debate around that new Fed chair and what that can mean for rates. My stocks are obviously very sensitive to rates, so we'll see how that goes.

So there's a lot on the fiscal/geopolitical environment that we're watching closely. And even at the conference, we do have panels that will focus on that.

Anne Malone (21:15)

That's great. I could talk to you for most of the day, but we better cut it off here. I appreciate your time.

This podcast was recorded on Feb. 10, 2026. Be sure to join us for our next Research @ Citi podcast, which will feature Rob Rowe and guests discussing nuclear energy. That's one you're not going to want to miss.

Feel free to explore our previous podcasts, all of which are available on this channel and other channels as well. And be on the lookout for our Research @ Citi Markets Edition podcast with a 10-minute breakdown of the equity and global macro markets, each and every week. Thanks so much, everyone. See you in Miami!

Disclaimer (21:50)