

Research @ Citi Podcast, Episode 23: Built to Last — Five Themes Shaping the Industrials Sector

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Transcript:

Andrew Kaplowitz (00:00)

Companies are splitting, merging more than I've seen. And again, my companies are always busy. But they seem even busier than usual, and that's something that's going to come up early and often at the conference, is: Does that create incremental value?

Rob Rowe (00:16)

Hi, everyone. Welcome to our Research at Citi podcast. I'm Rob Rowe, U.S. Regional Director of Research. And with me on the call today is Andrew Kaplowitz. He's our Industrial Super-Sector Head. We're very excited to have him because we do have the Industrial Tech and Mobility Conference coming up on February 18th to the 20th, which Andrew is leading. And so it'll be great to discuss some of the themes that inevitably will be coming up and that Andrew has published on that will be coming up in the conference. Thanks for being on with us, Andrew.

Andrew Kaplowitz (00:50)

Thanks, Rob, I'm really excited to be with you. We're very excited for the conference. This year is going to be our biggest and best conference yet. We have 140 companies.

Rob Rowe (00:59)

Wow.

Andrew Kaplowitz (01:00)

We already have over 600 clients signed up. So it's definitely going to be over 1,000 people, and we're looking forward to it.

Rob Rowe (01:06)

Fantastic. I wish I was going, Andrew, but I know we'll be getting notes from you later on, and I'm sure they're gonna be very informative. Why don't we move on to some of the themes that you've identified in a recent publication. No doubt that'll be addressed at the conference. I think the first one you mentioned is sort of a weak first quarter, but second half acceleration?

Andrew Kaplowitz (01:26)

Yeah, so a lot of my companies actually reported good results in Q4, but guided conservatively in Q1. And I think one of the things that investors are going to try to figure out at the conference is, is that just conservatism or is that still a pretty sluggish industrial economy that's expected to speed up as the year goes on? I think for what it's worth that there is some conservatism, I know we'll talk about geopolitics a little bit later. There's a lot of cross currents out there. But I think our companies, they don't really know exactly how '25 is

going to unfold. There were some green shoots, which I'm sure we'll talk about in Q4, but you don't want to extrapolate too much on that, so you want to start out the year slowly.

Rob Rowe (02:13)

And are there particular sectors right now— like, you mentioned green shoots, but are there particular sectors that have probably maybe a better growth multiple than say others?

Andrew Kaplowitz (02:22)

Yeah, it's a great question. So, look, we've talked a lot about electrical infrastructure, HVAC and automation as generally our preferred sectors. I think electrical infrastructure and HVAC have continued to be strong. Obviously, data centers seems to be pushing a lot of the electrical infrastructure and power markets, I would say, are related and also very, very strong right now. HVAC is more global sustainability focus that continues even with the new administration. I'd say aerospace is also quite strong, another sector that has been very resilient and still seems resilient as you go into 2025.

Rob Rowe (03:05)

Got it. And you mentioned— another theme as you mentioned, it would be a short cycle of recovery nonetheless. You're enthusiastic about the PMIs that you're seeing, which, you know, should give our U.S. economists some pause. But what do you see there?

Andrew Kaplowitz (03:20)

Yeah, Rob, “enthusiastic” might be a little strong. “Mildly encouraged” is probably the right words for that. You know, we saw the U.S. ISM peak over 50 in January. It's really only a second time in two years. New orders actually were pretty strong in the mid 50s. And it does seem like some of our companies did talk about some improvement in Q4 in short cycle markets. Classic sort of consumable-type end markets, maybe showing a little bit of signs of life; automation markets, maybe showing a little bit of signs of life. And I do find that encouraging, but again, it's really— green shoots is the best way to describe it. It's very early going of improvement. Literally, we've seen one month of U.S. ISM over 50. I'm not going to get overly excited yet. Let's put it that way.

Rob Rowe (04:18)

Okay. And maybe we can talk about megatrends, and I guess— and this is one of the more exciting themes for me, which ones are coming, which ones are going as you put it in your publication. And maybe we can focus a little bit on the continued automation of the industry and also maybe how you see AI playing out because I get the feeling that people are going to want to start to see, at least on balance sheet, where these innovations are starting to, you know, either improve operating leverage or improve efficiency in some way or even profitability. But is this a short or still a medium to long term development?

Andrew Kaplowitz (05:01)

This is definitely long term, Rob. I am pretty excited about the megatrends that I see, and I should say, I think they're gonna continue to be resilient. I've been covering industrials for over 20 years now. Time flies when you're having fun. We haven't really seen this many megatrends since the mid-2000s. You know, mid-2000 was the rise of globalization, and also energy infrastructure really drove that time. Actually, the opposite is driving this time, to some extent, deglobalization. When you get deglobalization it leads to the need for more duplication and what they call reshoring. And so we have seen relatively good evidence of reshoring so far through the pandemic and after the pandemic — certain end markets,

semiconductor, life sciences, you know, maybe even energy. You've seen more moving back into the U.S. from overseas, and I think that just accelerates with the new administration. So, you know, reshoring is still a big megatrend.

I think AI, as you mentioned, may be the biggest megatrend now impacting industrials. If nothing else, it's already impacting growth. We're seeing it. Data center proliferation leads to significant growth in lots of different areas from my companies, whether it's power-related growth, electrical-related growth, thermal management, for HVAC companies and so on. So significant growth for a lot of our companies that we think is actually still in the early innings. But what AI can also do is it can lead to increased productivity in industrial companies. You'd be surprised how a lot of our installed base here in the U.S. and factories, I think, still— let's just say, need some work. Efficiency is something that needs to be improved at these factories. They've come a long way over the last 20 years. But one of the reasons why we're still pretty bullish on margin expansion and industrials is because there still a lot of self-help needed for these companies. And it can come from AI, and that's the thing is that I think AI proliferation is still in its very early going for factory innovation and efficiency.

Rob Rowe (07:24)

Interesting. And are there— so the megatrends that we have are the reshoring and AI, and I think self-help was another theme. Are there other megatrends that you're thinking of?

Andrew Kaplowitz (07:37)

Yeah, thanks for that question. So it's also sustainability, and it's a very— I would say sustainability and energy transition are megatrends that are a little bit more debatable these days, given the new U.S. administration and their focus. At the same time, I think, you know, the proverbial horse has left the barn when it comes to sustainability. You know, regardless of what you believe about climate change, it does seem like, you know, weather is getting more severe. My water companies are tending to deal with more either droughts or flooding as an example. And so companies are sort of taking it into their own hands to improve their sustainability goals. I'd say it's also happening at the state, local level here in the U.S., and outside of the U.S., places like Europe still, you know, very important to focus on sustainability. So again, the thing is that it's the number of megatrends that's quite interesting in industrials these days, not just one or two, but several that we've just talked about.

Rob Rowe (08:43)

So it sounds like with sustainability, it's a matter of consideration of damages that could take place that they need to address, regardless of what the political climate is for climate change or anything else.

Andrew Kaplowitz (08:56)

I think that's right, and like, for instance, I think there's much more focus on something like wastewater, you know, recycling of water. Again, like, the U.S. West went through a major drought, I think it was two years ago, and that just raises awareness that you need to conserve water, as an example. On the HVAC side, again, like, there's a global decarbonization focus that continues. It does ebb and flow, I'd say, depending on the country or the time. But in general, lots of countries and/or, you know, municipalities or localities here in the U.S., you know, are demanding certain, you know— you've heard the term net zero? That's not going away.

Rob Rowe (09:44)

Right, right.

Andrew Kaplowitz (09:45)

And in some places, it's still accelerating. So I'd say there's that, and actually, I should mention one other thing, which is just the overall electrification of, you know, the world. You know, it's slowed down here a bit. I think EV transition has slowed down a bit, you know, in a place like the United States. At the same time, it does continue to seem like we're moving toward a more electrified world. And that does lead to significant investment in capex that's needed, you know, for my companies.

Rob Rowe (10:15)

And in terms of going back to the theme of self-help, you mentioned one thing, but there are others, right, in terms of how you look at margin expansion, et cetera.

Andrew Kaplowitz (10:27)

It's a really good question. So again, I think digitization— we can put AI in digitization.

Rob Rowe (10:33)

Sure.

Andrew Kaplowitz (10:34)

Digitization is a big form of self-help that my companies are still in the very early going in terms of their focus, but they are ramping up digitization as quickly as they can. And digitization generally comes with much higher margins and overall more efficiency. But at the same time, one of my reasons why my space is called multi-industry, and historically, it's called industrial conglomerates is because the companies generally do a lot of M&A. But I would say, actually, these days, it's more portfolio management versus M&A. They will continue to do a lot of mergers and acquisitions. That's what they do. And if you do have a little bit more stability in the geopolitical and interest rate environment, I think you could see a lot of M&A. But besides that, you're also seeing a bit of a deconglomeration of our companies. Companies are saying to themselves: Listen, we got to get more focused. And when we get more focused, we can improve growth and we can improve margin. And so we're definitely seeing a very active period where companies are splitting, merging. There's just a lot of stuff going on in that way, more than I've seen. And again, my companies are always busy. But they seem even busier than usual, and that's something that's going to come up early and often at the conference, is: Does that create incremental value?

Rob Rowe (12:05)

Great. And maybe we can also, Andrew, switch over to, as you call it, the rest of the world and geopolitical impact on industrials. And what I would ask first is as we go into that, you know, obviously a lot of the focus is on the Trump administration, a lot of the focus is on the U.S. because there's such tectonic change taking place. And, you know, obviously, two or three areas that are big are, you know, I would say tariffs, right? Inshoring in terms of what the Trump administration can do there, deregulation, you know, and also, I would say potentially corporate taxes. How do these things play out for industrials and industrial conglomerates? How does tariffs— are they a positive or a negative for industrials? I mean, I imagine some have a lot more trade on a foreign side, and retaliation could stop that trade. As you said, deglobalization. Are these all positives or are there positives and negatives to these things?

Andrew Kaplowitz (13:10)

All good questions, Rob.

Rob Rowe (13:12)

I know, and it's a lot to cover. *[laughs]*

Andrew Kaplowitz (13:13)

There's not one specific answer, but let me put it like this: Our companies are generally more than 50% U.S., or at least the companies I cover, which then by their nature means that if we are more focused inwardly on the U.S., our companies ultimately are going to benefit. So I think that's number one. Tariffs do lead to some near-term uncertainty. It's hard if you—especially if you don't have—how do I say this? Each day, there seems to be something new along those lines. And so you need more clarification and visibility about what these tariffs are actually going to be because if we knew the end game, then the companies would absolutely be able to plan for it. And ultimately, tariffs lead to price increases for our companies.

Now, I think it's not such a bad thing to have price increases that you can get margin on for our companies, but ultimately it can lead to higher prices for consumers, as you know, and so I think, again, you have to be balanced about how you look at these tariffs. I think reshoring and a focus on the U.S. ultimately is a good thing for my companies. But at the—and tariffs will lead to that. But at the same time, tariffs also lead to near- to maybe even medium-term uncertainty in terms of capex decisions, how it impacts the consumer. Does it slow down, for instance, the U.S. economy? Those are, you know, more not as good things that could impact our companies.

I think, ultimately, though, our companies tend to look at the new administration with, let's call it cautious optimism because, you know, it's a balancing act. Deregulation and lower taxes are generally a good thing for our companies, and that's what they want. But that is also balanced by tariffs, as we just talked about. And so I think what we've argued is it's going to be a little bit of a shaking out period. It's part of the reason why as you asked me, originally, the companies are guiding relatively conservatively to start the year is, I think it's going to take you know, another few months probably for us to figure out really where this administration is going and what the end game is. And once that happens, and there's a little bit more certainty or stability in the overall geopolitical backdrop, the companies can plan for it and they can spend. And so our view has been that while it's encouraging that, you know, we've seen a little bit of a PMI recovery here in the short term, we don't really expect a more consistent recovery until at least the spring or the middle of '25, because we think uncertainty will linger a little bit over the next few months.

Rob Rowe (16:14)

Yeah, and then there's actually probably a positive story behind that because I imagine industrials can sort of bob and weave with whatever these changes are and be able to direct themselves more efficiently after that.

Andrew Kaplowitz (16:27)

Yeah, and I'd say, Rob, like, we do talk about how our companies are global, right? So yes, they're majority U.S., but they also have exposure to Europe and Asia. And I think we're going to just have to see how these tariffs play out. I think our companies have been re-emphasizing the U.S. versus those other areas. But those other areas could continue to be a

bit lethargic for our companies as the U.S. actually potentially strengthens. So we just have to kind of watch that balancing act and see how it goes over the next six to 12 months.

Rob Rowe (17:01)

Got it. And if you're a global industrial company, do you think that you still favor tariffs, per se, or do you think that that could be more disruptive to your overall business?

Andrew Kaplowitz (17:14)

Well, I'll just say it like this, Rob. If I were the CEO of one of these companies, I probably would think it's a little bit disruptive.

Rob Rowe (17:20)

Yeah.

Andrew Kaplowitz (17:21)

At the same time, again, like, it's not just about tariffs if I talk to this administration, right? They have to pay for their tax cuts. You know, they are set to expire. But I think this is part of their strategy, and deregulation and smaller government is part of their strategy. And theoretically, if you put more incentives in front of the private sector, you know, like my companies, you could generate more growth. So it's definitely a balancing act that maybe we can talk to our economist about as well.

Rob Rowe (17:56)

Sure. Sure. And lastly, Andrew, there are regions of the world where I think you see opportunity in regions of the world where maybe we'll stay a little bit more static?

Andrew Kaplowitz (18:08)

Yeah, it's a great question. Again, I definitely see opportunity in the U.S. We might have a little bit of a shaking out period— shaking out's the wrong word, but a little bit more uncertainty here over the next few months as we kind of see what the administration's exactly going to do. But I think U.S. definitely is getting a lot of emphasis these days from my companies and in general. And I think that's going to mean better capex and, you know, continued growth environment here. I'd say internationally, you know, there are places like India and the Middle East, which at least for my companies are doing quite well right now and continue to grow, and become a bigger portion of my companies' sales mix. So, they might over time replace some of the more traditional high-growth markets of the past. So we're watching that closely.

Rob Rowe (18:57)

Fantastic. Andrew, we've come up on our time. I look forward to hearing feedback and notes from the conference on February 18th, on the Industrial Tech and Mobility Conference. Really looking forward to those notes from you afterwards. Thanks so much for being on the podcast with us today. Lot of great insights here. Thank you very much.

Andrew Kaplowitz (19:19)

Rob, thanks for having me.

Rob Rowe (19:21)

I'll be coming back at you in a couple of weeks with our next podcast, which will feature Nick Joseph and a discussion of the REIT markets, the REIT sector, which is going to be just before his conference in March. Thanks, everybody, for listening. This episode of Research @ Citi was recorded on Wednesday, February 11th, 2025. I'm your host, Rob Rowe.

[Disclaimer] (19:46)

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