

Exchanges at Goldman Sachs with Matt McClure
Hosted by Allison Nathan
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Allison Nathan: This is Exchanges at Goldman Sachs where we discuss developments currently shaping markets, industries, and the global economy. I'm Allison Nathan, a Senior Strategist within Goldman Sachs Research.

Today we're diving into the latest in the industrial sector which includes everything from housing and manufacturing to machinery and airlines. And is a space that's seeing a surge in activity. To do that, joining me is Matt McClure, Co-Head of the Global Industrials Group in the Investment Banking Division here at the firm.

Matt, welcome back to the program.

Matt McClure: Thanks Allison.

Allison Nathan: Matt, you were last on the podcast in September. And at that time, the window for M & A activity was really just starting to open up again as companies were beginning to position themselves for the post-pandemic economy. That momentum has since accelerated. We've seen record volumes of M & A. we've seen some very large transactions. Talk about the activity you've been seeing in the industrial sector.

Matt McClure: Well, to start, obviously there's been a continued shift in sentiment and a return of confidence amongst the industrial companies since we last talked. With the impact of COVID increasingly in the rearview mirror, corporates are, frankly, risk on when it comes to allocating capital to M & A. Their conviction in the strength of the economic recovery, continued low rate environment, coupled with shareholder receptivity to transactions has really created ideal conditions for deal making.

So, put that in context. We've seen record levels of industrials' M & A activity this year. With volumes increasing 160 percent year over year. And transaction M & A count up something like 140 percent. So, activity levels remain high across all sectors. In particular we'd say transportation, auto tech, building, construction are places where we've seen heightened levels of activity. Strategics continue to want to put capital to work. And, in particular, are focused on

executing their dream deals. I think a great case in point is the recent consolidation we've seen in the rail sector involving Kansas City Southern. And on the private equity side, there continues to be unprecedented amounts of capital to be deployed with increasingly large buyout funds on the hunt for larger opportunities, facilitated by continued attractive terms that are being offered by the debt markets.

Allison Nathan: Industrial companies historically include mature businesses without a lot of need for near-term growth capital. But lately your team has seen a lot of IPO mandates. What's driving that activity? And do you expect it to continue?

Matt McClure: You're right that IPO activity in industrials has been robust. And overall, investor receptivity strong. We've seen eight industrial IPOs this year representing 3.5 billion dollars of IPO proceeds raised. And many of these companies have been capitalizing on investor appetite around specific COVID beneficiary themes.

So, for example, we've seen pool pump manufacturers and fiberglass pool product manufacturers going public. Both catering to the concept of outdoor living and both entering the public markets at attractive multiples. We've seen companies that are playing on the theme of infection prevention and sanitation, which obviously resonates strongly in the current environment. And lastly, we've seen airline companies which offer investors exposure to the reopening trade, underpinning leisure travel specifically IPO in 2021.

In addition to the secular trends emerging from COVID, ESG positioning continues to be critical with investors. And helps cultivate a broader audience when we're taking these companies public.

But the remainder of the year we're likely to see industrial IPO activity emerge in sectors such as building and construction, business services, and industrial technology. And as is typical for the industrial world, the private equity community will continue to be the largest source of those IPOs.

Allison Nathan: Okay, great. I do want to dig into some of these individual sectors a bit more. But before we do that, I think it is hard to talk about the IPO market these days without talking about SPACs. They've obviously been in the headlines this year. Early in the year we just hearing about the acceleration in the SPAC boom. But more recently the focus has

been the cooling in SPACs, a fall off in activity. So, what should we make of SPACs right now? And how are you talking with your clients about SPACs versus IPOs as you head into the second half of the year?

Matt McClure: It's a great question. And look, despite the recent slowdown in new SPAC issuance amongst these SPAC transactions, we shouldn't forget it's been an incredibly robust first half of the year in terms of SPAC market activity. So, globally, 325 SPAC IPOs that are priced in 2021, over 100 billion dollars of capital raised. There's been something like 230 SPAC-related mergers representing over 500 billion of enterprise value. So, despite the choppiness recently in that market, overall, you know, there's been a ton of activity this year.

In industrials specifically, more than 35 of these mergers are companies in the auto tech space. So, that includes things like sensors, EDAS, batteries for electric vehicles, software, et cetera, that have raised over 25 billion dollars in capital and represent over 100 billion dollars in combined enterprise value.

You know, in the last few months, obviously, the SPAC market has become a bit more challenged. And given the rotation out of gross stocks into value stocks in industrials, auto tech has been at the forefront of that. And auto tech companies typically are higher growth companies with longer dated forecasts in expectations. So, you've now got a number of those entities that are trading at below where they'd like to be.

That said, overall, with just the enormous amount of capital that sits with SPACs that needs to be put to work, and the M & A dry powder that that capital represents, we continue to think that the SPAC market is going to be active and an attractive vehicle for sellers to utilize. And compared to other forms of exit, SPACs continue to offer a number of features that can be quite distinct from a seller's perspective. That said, you know, in the near term, there's probably going to continue to be some ongoing [UNINTEL] activity amongst pipe investors on where they deploy their capital. And we could well see some valuations continue to be under pressure.

Allison Nathan: So, let's dig into specific businesses that you've touched on that have been particularly active, starting with airlines. They're finally buzzing again after what felt like a never-ending drought of suspended or significantly reduced operations and urgent capital raises. What types of

conversations are you having with these clients today?

Matt McClure: Well, for the airlines, it's obviously a very different world versus this time last year. And it already feels like the recovery is well under way and will really take hold this summer, starting with leisure and then moving into business travel perhaps more gradually. And with that, we're likely to see a shift in airline sentiment from preservation of cash flow and liquidity to being more back on the offense. And that could materialize in a number of ways, perhaps undoing some of the more expensive elements associated with some of the capital that was raised in government aid in 2020, with a view to more normalized conditions assessing the appropriate run rate level of liquidity and leverage profiles in a post-COVID environment.

And then I do think you're going to see some of the airlines looking to make strategic investments in some of the regional players or players that need capital to enhance their networks.

I would say that ESG continues to be a major area of focus for the airlines, with many of them looking to take a much more proactive stance on the topic. Interested in creative ways to meaningfully address their potential customer and investor concerns, whether it's through carbon credits or green investments or newer efficient aircraft, et cetera. And obviously, a number of our clients have been digesting the potential implications of the recent Exxon Engine No. 1 proxy fight, which was really the first instance of a successful attack on a mega cap company where ESG was really at the core component of the activist thesis. So, obviously that's been front and center with a number of the airlines.

Allison Nathan: And what are you seeing in the cruise line space?

Matt McClure: So, for the cruise lines, they operate in circumstances that they find themselves in are different from the airlines. And unfortunately, at least near term, there remains more uncertainty around their return to sail, which continues to be pushed out. And frankly, isn't uniform at this stage across all geographies. And not surprisingly, while there's been a real recovery in their stock prices, many of them remain at between 60 to 70 percent of the pre-COVID levels. So, they're still depressed versus where they've been historically.

You know, the summer sailing season is obviously the most profitable part of the year for many of the cruise liners. So,

to the extent that they can get up and running and sailing in the near term, that could have implications for the balance sheets. That said, for companies like Norwegian Cruise and others, the future pipeline of business looks really attractive. Their order backlog is up materially year over year. So, there's a lot of pent up demand and a lot of soreness to be positive around that industry.

From a balance sheet perspective, most of the large cruise lines have now completed substantial capital raises over the last 12 months and cut their cash burn to an absolute minimum. And as sailing resumes, I think conversations with those clients are going to turn to how do we retool our balance sheet for a more normalized, post-COVID environment.

Allison Nathan: The home building space is almost the opposite story, right? Home building and renovation activity is through the roof. I think our Chief Economist Jan Hatzius referred to it as "on fire" in a recent GS research report. Talk about that space.

Matt McClure: Home builders and building products manufacturers continue to perform extremely well in 2021. Demand remains very strong. And the builders and manufacturers have been able to mitigate headwinds like expensive lumber pricing and labor wage increases with larger price increases. So, this will be a near record year for the margins for those home builders and building products manufacturers, despite the significant cost increases.

The consensus a year ago was that the key driver of the increased momentum was this concept around the flight from cities due to COVID-19. While there's an element of truth in that, we believe the major underlying drivers are what has historically always caused housing activity to accelerate, being a low interest rate environment, demographics, and low supply. Otherwise said, our view is it's unlikely that the reopening phenomenon post COVID will have a detrimental impact on housing or building products demand. The drivers are there. And we think this has room to run.

Allison Nathan: Let's touch quickly again on auto tech, which you mentioned was an industry that was fueled, in part, by the SPAC boom. How is activity in that space continuing to evolve?

Matt McClure: Well, there's a broad spectrum of players in the auto tech universe. On the one hand we have the worlds largest

OEMs who obviously are bringing EVs or electric vehicles to the masses over the next few years. The commitment is there. The capital investment is there. It now comes down to execution and customer adoption. This year, the OEMs have had the added challenge of having to contend with massive chip shortages, which they continue to work their way through.

What's been most impressive is to see some of the OEMs, such as GM, have their stock prices rerated this year. GM's stock is up over 50 percent year to date as investors in the market have rewarded their successful strategic pivot towards EV in recent years. On the other end of the spectrum, you have a number of players that are attempting to become the next Tesla. And you know, those successful EV companies who are somewhat advantaged by starting with a blank operating slate, and therefore able to attract the appropriate investment and human capital.

Between those varieties, you know, we expect to see more collaboration and potentially more consolidation across the industry as it starts to mature a bit. A weaker SPAC market, we don't think, is going to be an impediment to companies innovating and executing. The capital was always there. It might just come in a different form.

Allison Nathan: ESG has come up several times in this conversation. You mentioned it in the context of airlines and, of course, auto tech. What other industrial sectors seem to have a lot of white space for innovation and sustainability?

Matt McClure: A number of industrial clients are looking for ways to refine and expand their sustainability strategy around ESG, which is a topic that continues to evolve. In some cases, it involves us helping them think through how and where best to invest their capital towards carbon neutrality, which requires an assessment across various climate investment themes to determine the right fit to meet the client's sustainability objectives. In other situations, we're helping them think through ways to build direct partnerships with institutions such as ourselves, where our ESG strategy overlaps with theirs and there might be potential synergy. Lastly, in certain circumstances we're in the lab with our transportation clients on potential green financing solutions.

ESG has really brought a new dimension to our client dialogue, where we've been able to expand and help them think through a number of factors, such as increasing diversity in the boards and [UNINTEL] oversight and accountability of performance of

both environmental and social risk.

You know, we recognize that ESG is a fast moving topic and is going to continue to morph quickly. And therefore, our clients and ourselves need to be nimble around how we're structuring solutions to accommodate ESG overall.

Allison Nathan: And Matt, before we rap up, what are one or two things in which you see the biggest opportunities in the industrial space over the next 12 months? And what are one or two things that keep you up at night?

Matt McClure: So, I've been covering industrial companies for almost 20 years. And one of the things I find really attractive about this space is just the wide range of sectors and end markets that you're exposed to. And the impact of COVID has obviously been very pronounced on some sectors and less pronounced on others. We talked a lot about the transportation space, for example. That's going to be in the coming out of COVID, the pace of recovery is going to differ depending on the end market you're exposed to. And it's also going to mean that your priorities are going to differ. We're going to see some companies that are very focused on the acceleration of technology and digitization. You're going to see some companies which are going to be much more on the front foot in terms of trying to deploy capital on the M & A and execute their dream transactions.

So, I think going forward, you're going to continue to see a broad range of different types of activity depending on the sector within industrials.

In terms of what I'm worried about, I would say it's more around the macro. So, obviously to the extent that the economy starts overheating, we see inflation really tick up. What does that mean in terms of the operating performance of industrial companies? And obviously, the impact of potential tax policy and the uncertainty that that creates around appetite for industrial M & A.

Allison Nathan: Thanks very much for joining us, Matt.

Matt McClure: Thanks Allison.

Allison Nathan: That concludes this episode of Exchanges at Goldman Sachs. Thanks for listening. And if you enjoyed this show, we hope you subscribe on Apple Podcasts and leave a rating

and comment.

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