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Europe's manufacturers are in good shape for a downturn

After reorganising themselves over the past 10 years, many European manufacturers have more flexible business models with higher returns

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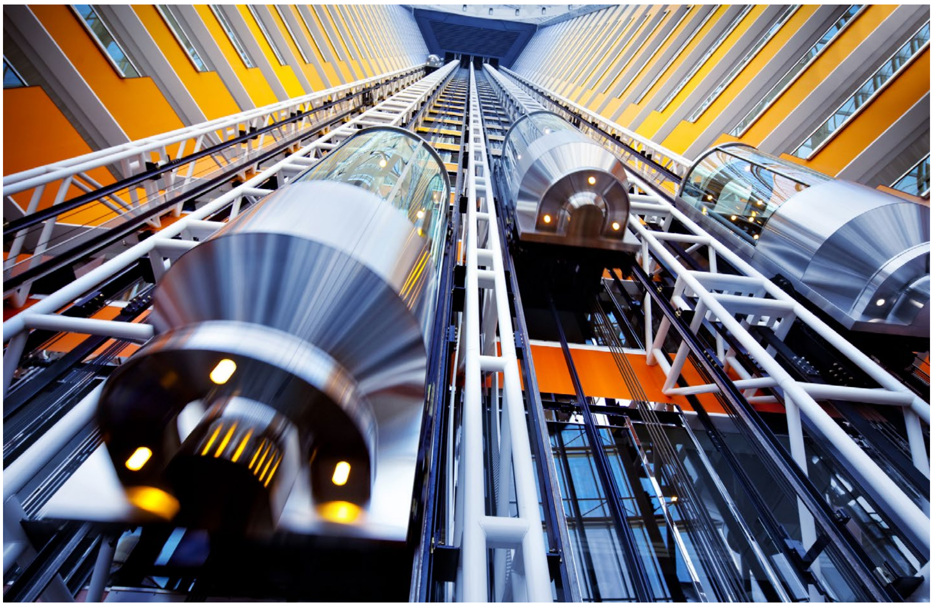
Europe is rich with manufacturing companies. It has 1,400 groups listed in the industrial sector,[1] the largest sub-group being manufacturers of capital goods. Alongside these are aerospace and defence businesses, transportation companies, and a wide range of companies providing services for industry and manufacturing.



Within this diverse landscape we are overweight the capital goods sector. We hold companies based all over the continent, with a greater concentration of large groups in Northern Europe and the Nordics, and a sophisticated ecosystem of small- and medium-sized manufacturers in Italy.

Although European manufacturers face major disruption during the battle against the effects of Covid-19, many of them have strong long-term attractions and can survive the current slowdown.

Flexible cost bases

Over the past decade many manufacturers have faced huge pressure to reduce their supply chain costs and have responded by transforming the way they operate. Much has been outsourced, and many manufacturers now produce only the most critical components with the highest intellectual property content.

The shift to an "assembly" business model has changed the financial characteristics of these companies. They are more asset-light, boosting returns on capital employed. This helps to reduce fixed costs, enabling European manufacturers to flex their cost base more easily in a downturn and leaving their returns less exposed to turns in the business cycle.

However, the flipside of this transformation is that European manufacturers have developed more complex and international supply chains. This exposes them to greater risks of disruption, for example due to the increased inputs sourced from China.

Asset-light elevator businesses

The elevator industry is typical of the transformation in European manufacturing. A highly consolidated market with long-term structural growth thanks to urbanisation trends in emerging markets and high demands for safety and reliability. Europe boasts three of the four leading global lift manufacturers – Kone of Finland and Schindler of Switzerland, both of which are listed, along with the former Thyssen-Krupp elevator division which was recently sold to private equity. The fourth global player is Otis of the US.

Of the four, which control 60% of the global market, Kone is one in which we have long-term holdings in our European funds. Today, the Finnish company has an asset-light assembly business model with excellent financial characteristics. Its secret to high margins, however, is maintenance. No one likes getting stuck in lifts. So developers and building managers pay a fixed amount a year to keep each elevator running smoothly.

- Margins are 2-3x higher for service than for new equipment, and revenue from maintenance is far more stable than that from installations, where volumes are affected by economic cycle.

In a typical elevator sale Kone invoices for pre-payment before delivery and profits from long-term contracts to service and maintain the lifts it installs, diversifying its profit stream and generating steady and predictable cash flows.

Over the past decade, China has become a major source of growth for Kone, thanks to a massive urbanisation drive. This has powered annual revenue growth of 6%, so China now accounts for 30% of its business. The country installs more than 500,000 lifts a year – two-thirds of the global total, and which compares with a US installed base of just 900,000.[2]

Kone's China growth

As the world's largest market for elevators, China is central to Kone's future growth. But it differs in important ways from the European and US markets and much will depend on how long the differences persist and what Kone can do to overcome some of the drawbacks.

In Europe and the US, Kone makes modest margins on sales of new lifts but signs multi-year contracts to maintain them, which generate margins 2-3x higher than what they can earn on installation. As a result, Kone's service arm produces half the group's global profits. In China, by contrast, elevator sales command higher margins than elsewhere while service contract density is much lower, and services are less profitable. Many lifts are sold there through local distributors who provide the service themselves; while the big four capture 90% of new elevator sales, they only claim 30% of maintenance deals.[3] This leaves them much more dependent on new sales for growth than elsewhere. The vast Chinese servicing market will remain fragmented in the short term, but it represents a long-term consolidation opportunity for the global players.

China's elevator market is likely to remain steady at more than 500,000 units a year, and equipment sales will continue to be the main source of profits. However, leading players including Kone will capture more maintenance deals connected to those new sales – the "attach rate" – as they progressively replace third-party distribution with direct sales. They will also benefit if consolidation among property companies leads to bigger developers signing maintenance contracts on large portfolios of properties with the leading companies, rather than low-cost local suppliers.

Innovation offers further scope to improve the maintenance business. Regulators require every lift in China to be visited by two engineers twice a month, although the major elevator groups are installing sensors in new lifts to enable remote monitoring. Kone already monitors 5% of its global elevators remotely and charges a premium for this service.[4] It is running a pilot in China to demonstrate that remote monitoring means the existing inspection regime is no longer necessary.

It is not clear whether China will evolve to become more like other major elevator markets, but despite this caveat Kone remains well-positioned among the big four. It has a leading position in a consolidated global market with high barriers to entry where quality and safety are critical.

> "China now accounts for about 30% of Kone's business, and the country is expected to maintain its recent trend of installing at least 500,000 lifts a year

[1] MSCI Europe IMI Index as at 20 April 2020.
[2] Kone 2019 Capital Markets Day.
[3] Columbia Threadneedle estimate based on research and engagement with the company and its customers.
[4] Kone 2019 Capital Markets Day.