Corporate America: Innovative and healthy

Perennial International Equities Team

- Headed by: Clay Carter
- Seven investment professionals with an average of 16 years industry experience.

Recent US visit

- 41 companies
- 5 cities including Florida, San Francisco and Seattle
- Sectors and sub sectors: Aviation, IT, Internet, telecommunications, media, banking and finance.

This quarter, we shift our focus from Australian to international equities. Following his US site visits during the quarter, Graham Hay from the Perennial International Equities Management Team updates us on his views of corporate America.

We recently completed an almost three week tour of companies in the United States taking in Florida, Seattle, San Francisco, Silicon Valley and San Diego. Our meetings spanned the aerospace, telecommunications, technology and industrial sectors where we completed just over 40 meetings in all. Our overall impression of corporate America remains very positive. In our view, there is no doubt that American firms have adapted to the changed economic landscape faster than any other companies we know of. Corporate profit margins and cashflows are running at record levels, some argue unsustainably high, in spite of the lacklustre trends evident in the economy. With the overhang of the housing bust in America and persistently high levels of unemployment, it will be some time before America emerges from this period of sub-trend growth. However, these headlines hide the dynamism and innovation that is going on within corporate America, which continues to lead the world in many industries.

We had the opportunity to spend time with one of our holdings LKQ Corporation (LKQ) in Florida where we met with Ray Hammock the General Manager of its Orlando based scrap and salvage yard. LKQ have built an exceptionally strong business in supplying alternative parts to the collision repair industry. Alternative parts are increasingly being used in place of the more expensive original parts to repair cars after an accident. With a majority of automotive repairs being settled via insurance, it is the insurers themselves that are driving the adoption of alternative parts. This approach results in savings of up to 50% on the cost of a claim, thereby allowing fewer vehicles to be written off. Our tour of the facility highlighted how refined LKQ's salvage processes have become. With its national distribution network and sophisticated logistics operations, on 95% of occasions the company is able to turn around a purchase order in under 48 hours. We also learned that the company drain any excess oil and fuel from vehicles and sell this to a local merchant, providing nice incremental cashflow from each vehicle salvaged. All in all, the visit reinforced our conviction around our holding and with their foray into the UK market, we see the company continuing to deliver above average rates of growth over many years to come.

Graham Hay onsite in Florida at LKQ Corporation's salvage yard.

We also spent time with aerospace concern BE Aerospace (BE), a company we have since added to our portfolios. BE is a leading supplier of aircraft interiors for the commercial aviation market and benefits from its extensive installed base and high barriers to entry created by the very strict certification process for suppliers in the industry. At the end of 2011, the company had a backlog of business equivalent to 2.5x its current annual revenues. BE continues to grow this backlog through innovation and some key trends in their end markets. Among these trends is the growing mix of wide-body aircraft, servicing the growth in long haul air travel out of Asia, the Middle East and Latin America. BE stands to benefit significantly from this trend, with wide-body aircraft carrying up to nine times the dollar value of BE's content relative to a comparable narrow body aircraft. With wide-body aircraft deliveries expected to grow at a compound rate of almost 20% over the next five years, and BE's leading position in their end markets, BE in our estimation looks extremely well positioned to profit from this trend.

We believe the coming industrial renaissance of America will become an important investment theme over the next decade. We see a broad rethink underway regarding the merits of Asian based manufacturing, with the cost advantages that this shift initially brought being eroded by rising wage inflation, structurally higher freight costs, reduced manufacturing flexibility and ever persistent concerns around intellectual property. We will stay especially tuned to developments on this front and look to profit from opportunities here as they arise.

Graham Hay
Portfolio Manager, Perennial International Equities Management