Artisan Partners Global Equity Team

Infrastructure's Dual Tailwinds

Resilient Growth

April 2024

Over the past 10 years, the terms "reshoring" and "nearshoring" have increasingly become part of boardroom lexicon as companies have grappled with the best way to get their products to market. Trade wars, hot wars, rising technology transfer costs and a myriad of government stimulus programs in recent years have moved these conversations into actions at an accelerating pace.

Reshoring, or relocating manufacturing to a home market, and nearshoring, relocating manufacturing closer to a home market while still enjoying the benefits of low labor costs, are gaining momentum. A recent survey showed that 62% of companies with manufacturing operations outside of the US have begun to re/nearshore, resulting in a significant migration of manufacturing jobs to the US. Connecting these new locations, transportation companies anticipate 20% of Asia-originating freight will move to closer-proximity markets by 2025, 43% by 2029. Other supply chain strategies are also emerging. For instance, China Plus One—building parallel capacity outside of China to diversify risk—has also become a popular way of gaining optionality, especially in the electronics and automotive industries. Given the economic and political benefits these trends convey to companies and policymakers alike, many believe this movement will propel infrastructure investment in North America and Europe for years to come.

Interceding this secular trend, COVID-19 shut down economies across the globe and upended the normal business cycle by creating a new one that reflected extreme distortions in supply and demand. Resulting bottlenecks and shortages affected 98% of global supply chains, which accelerated reshoring and nearshoring trends and added fuel to infrastructure spending.

The Artisan Global Equity Team, led by Portfolio Manager Mark Yockey, CFA, seeks to invest in companies best positioned to benefit from these secular and cyclical tailwinds. Supporting Yockey and spearheading the infrastructure investment theme, Portfolio Manager Andrew Euretig researches these companies. With over two decades of industry experience, an MBA from UC Berkeley, and a background as an Amphibious Operations Officer in the US Navy, Euretig has first-hand experience with global supply chains. "After a two-year pandemic hangover, we're witnessing a cyclical inflection and have reasons to be optimistic for prolonged secular tailwinds." In other words, these trends have resulted in several significant outcomes: a boom in manufacturing investment, heightened demand for air travel and a reset of the freight cycle.

US Construction Boom

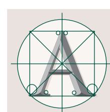
Manufacturing, nonresidential and residential construction is surging in the US. Anchored by computer, electronics, and electrical businesses, real manufacturing construction spending has increased by more than 200% since the end of 2021 as more companies bring jobs back to the US.

Investment Risks: Investments will rise and fall with market fluctuations and investor capital is at risk. Investors investing in strategies denominated in non-local currency should be aware of the risk of currency exchange fluctuations that may cause a loss of principal.

Andrew Euretig
Portfolio Manager

"Both political parties in the US have galvanized around the need to bring jobs back to America. Europe has the same issue."

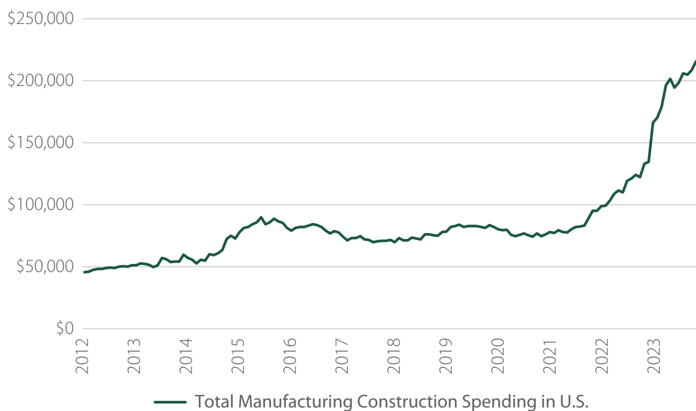
—Andrew Euretig



Government stimulus has been a large driver in this construction. The $52 billion CHIPS Act has played a lead role by providing a 25% tax credit for companies that build facilities in the US. According to the Semiconductor Industry Association, over 83 new semiconductor ecosystem projects have been announced since the landmark legislation was enacted, sparking hundreds of billions of dollars in private investment. These projects span investments in new foundries, chip design software developers, semiconductor materials and equipment makers, and research and development. In addition, the Bipartisan Infrastructure Investment and Jobs Act authorized $1.2 trillion for transportation and infrastructure projects, including water, power, broadband and power grid improvements, among many others. Lastly, the Inflation Reduction added billions more in incentives, grants and loans toward infrastructure investments in clean energy, transportation and environment. Altogether, these government programs could add over $2 trillion in spending to the US economy over the next 10 years.

Exhibit 1 shows how reshoring trends and government stimulus programs have led to the largest manufacturing construction boom in decades, adding an about 365,000 new jobs in 2023.

Exhibit 1: Total Manufacturing Construction Spending in U.S. (USD $M)



Source: Federal Reserve Economic Data (FRED), 31 Dec 2023.

This growth in construction spending is fueling record revenue growth for companies that supply these projects including companies like CRH, an Ireland-based building materials manufacturer. It benefits from owning hard assets in the US—such as buildings, equipment, plants and warehouses—where demand is strong given the current upcycle. It directly benefits from the broad utility of the essential building components it sells, such as asphalt, cement and aggregates. Importantly, as North America's largest building materials company, it also benefits from positive cyclical trends of a growing US economy as well as secular reshoring trends. Together, these dual tailwinds should support demand growth for years to come.

Resurgence in Air Travel

Boeing 737 MAX 10 airline crashes in 2018 and 2019 and a mis-installed plug door on a 737 MAX 9 plane resulted in a series of investigations and groundings that have hindered Boeing's capacity in recent years. As one of only two major commercial airplane manufacturers, this diminished output led to a drop in orders for Boeing from 2018 to 2022 and a significant decrease in deliveries from 2018 to present. Added to this, labor and parts shortages have further challenged the aerospace industry.

While many of these problems pre-dated COVID-19, the pandemic hit airlines particularly hard. The idea of being stuck shoulder-to-shoulder in a metal tube sharing recycled air with strangers for hours contributed to a plunge in air travel. As demand fell, most airlines mothballed their costly fleets and immediately reduced their workforces. When demand recovered in 2021, travel's massive resurgence put renewed pressure on airlines around the globe to increase capacities.

In this capacity-constrained, capital-intensive industry, Euretig and the team look for companies with hard asset values that can appreciate over time and strong pricing power, particularly in the aftermarket (e.g., maintenance, parts and service). One example is Airbus, Boeing's main rival. The European plane manufacturer pulled ahead of Boeing in 2018 and has since captured nearly 60% of the narrowbody market, the aircraft design preferred by most carriers. Airlines are expected to double the size of their narrowbody fleets in the coming years.

In addition, the team likes General Electric Aerospace (GE) and French manufacturer Safran. Separately and jointly, through a 50/50 joint venture called CFM International, these companies make about 50% of the world's commercial jet engines. Like the well-known razor and razorblade analogy, airline engines are typically priced to maximize profits over time through service and maintenance agreements with the installed base of airlines. Both the engines and these lucrative contracts have increased in value. Supply constraints, aging fleets, and escalating demand for air travel have spurred airlines to invest more in expanding and upgrading their fleets. Safran's ability to increase prices by 28% since November 2022 is a testament to its pricing power that has led to growingoperating margins.

The team also appreciates companies with high-value order books, or available capacities, that can be leveraged to meet the growing demand. For example, Ryanair, a leading low-cost airline based in Europe, continued to increase the size of its fleet, added routes and even expanded flight schedules to grow in markets where competitors had cut. The carrier emerged from the pandemic with an exceptionally strong balance sheet enabling it to order 150 more planes and secure options for another 150, depriving competitors of being able to add similar capacities. By mid-2024,

Ryanair plans to have 600 aircraft in operation, solidifying its spot as one of the largest carriers in the world. This growth has enabled the carrier to capitalize on the surge in demand for air travel more than other carriers. In addition, Ryanair's low-cost strategy gives it room to raise fares as needed while maintaining full planes. For example, Ryanair's operating expense per available seat mile—the variable cost of flying one seat one mile—is about 6.79 cents. This includes fuel, labor, maintenance, depreciation and airport fees. For a higher-cost competitor such as British Airways, this amount is 13.18 cents, almost double Ryanair's seat mile cost.

AerCap is another portfolio holding with valuable capacity. It provides a wide variety of aircraft leasing services to the industry. In recent years, AerCap has benefited from supply disruptions in the industry that have increased demand for its fleet. As lead times for new aircraft orders continue to lengthen, AerCap's inventory of planes fetches ever higher market values as they come off leases, generating growing profits for the firm. Andrew and the team are attracted to AerCap's leverage to aircraft demand in addition to the quality of its fleet.

One axiom in the aerospace industry is that the higher an airline can price a seat, the more it needs planes and engines, and the more valuable its order book becomes. Euretig elaborates:

"So, we own the planes in Airbus, the engines in GE and Safran, and the order book in Ryanair and Wizz Air. It's a virtuous circle for now. Each company generates value for the other, and all benefit from greater pricing power given their strong positions in a supply-constrained market."

"We've always appreciated the secular growth in airline travel given the favorable demographics. Now the supply side is a casualty of COVID disruption adding to the investment opportunity."

In an industry that has not traditionally benefited from pricing power, the opportunity of the current supply and demand imbalance becomes clear.

"In the US, airlines are basically charging passengers 20% more than pre-COVID levels and GE and Safran are charging the airlines 30% more," Euretig summarizes. "We think this is a template for what Ryanair and Wizz will face over time."

While such pricing data such are encouraging for suppliers over the medium term, the team still believes favorable demographics will continue to drive demand over the long term. Trends show that as more baby boomers retire, millennials trade home purchases for experiences, and countries develop economically, the demand for air travel will likely continue to grow.

Freight Reset

During the pandemic, the demand for goods and services initially plummeted as people stayed home and economies shut down to arrest the spread of the virus. Months later, as economies began to reopen, demand surged at a time when businesses around the globe were still dealing with supply delays. Lead times lengthened, shipping costs ballooned and product shortages became widespread. Meanwhile, freight containers piled up at ports due to severe bottlenecks. To account for these longer lead times, many retailers ordered far more than what they immediately needed, creating a bullwhip effect throughout the global supply chain. Inaccurate demand predictions can cause the gap between supply and demand to grow bigger over time.

By the time freight deliveries began to catch up with orders in 2022, supply was already outstripping demand, leading to excess inventories at a time of rising interest rates and carrying costs. Predictably, retailers slashed orders, which led to the present-day global freight recession, one that has been in place since late 2022. A shift in consumer preferences from goods to services exacerbated the inventory gluts, even as this change created new opportunities for service providers such as the airlines.

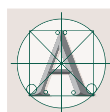
When economies shut down in 2020, railroads provided a reliable and efficient mode of moving goods enabling them to gain market share in freight transport. However, given their structured schedules and geographies, railroads lacked the flexibility that trucking offered to shippers. In 2021, when containers were stacked on the docks, shippers valued speed and flexibility over reliability, causing revenues to fall for railroads.

Today, however, it appears that rail prices are slowly recovering, reflecting gradual increases after a sustained trough. This metric bodes well for potential margin expansion given the industry's high fixed costs. In fact, rail pricing in the US has been increasing faster than the pricing for the broader transportation industry.

This movement—one that Euretig monitors closely—is one of many indicators that leads him to believe railroads will once again be able to leverage their unique assets and pricing power in the near future. He explains, "The average company has increased prices by 75% over the last two decades. Rail pricing has gone up by 115% over that time."

The compounding effect of these price increases has translated into steady profit growth and stock price resiliency. North American railroads have outperformed the S&P 500 for two decades based on pricing power and productivity.

What has led to this pricing power? "Massive industry consolidation over the years," Euretig responds. In 1980, there were 40 Class I or major railroads operating in the US. This number fell to six with the 2023 merger of Canadian Pacific Railway and Kansas City Southern. The consolidation



led to increased economies of scale, higher productivity, as measured by average revenue ton miles, and more concentrated pricing power. The revenue earned for transporting one ton of freight one mile is an important indicator of industry profitability.

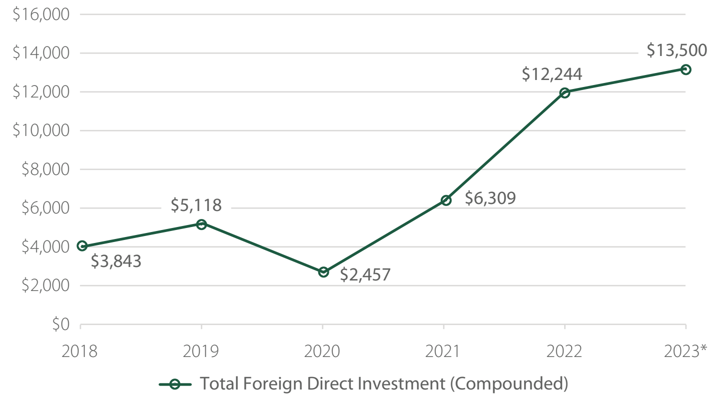
"Some investors questioned whether the secular growth story of railroads was disrupted during COVID. We took the opposite view."

The team believes that Canadian Pacific Kansas City Limited, now known by the trade name CPKC, and Canadian National Railway are well-positioned among the remaining companies and have the strongest routes in North America. The team has invested in these companies, off and on, for decades. Both Canadian railroads connect multiple West Coast, East Coast and Gulf Coast ports providing many options for global shippers seeking to avoid bottlenecks. Also, with the merger, CPKC can now directly connect manufacturing centers in the US, Canada and Mexico, providing greater value for shippers and productivity for the railroads. For example, agricultural producers in the Canadian and US heartland can ship grains and other commodities to food processors in Mexico. On the return trip, auto parts makers in Mexico can ship directly to the US in a matter of days and enjoy a favorable composite tariff rate of 0.04%. This rate compares to China's composite tariff of 19.2% and transit times to and from Mexico are usually measured in days, not weeks. In addition, both railroads stand to benefit from a cyclical rebound in freight revenues as well as from reshoring and nearshoring trends.

Since 1994, the North American Free Trade Agreement and its successor United States-Mexico-Canada Agreement have led to a 565% increase in US exports to Mexico and an 864% increase in US imports from Mexico enabling each country to become each other's second-largest market for goods. With aligning time zones, lower language barriers, reduced risk of geopolitical disruption, faster shipping times and a labor cost often less than China, Mexico is a natural fit for North American companies looking for nearshoring opportunities. Improved transportation infrastructure and special economic zones for manufacturing, which offer reduced duties and simplified customs processes, only add to this country's appeal. For railroads serving this geography, the opportunities for increasing cross-border traffic have increased as more companies move their manufacturing hubs from Asia to Mexico to take advantage of this relationship.

Reflecting these benefits, foreign direct investment from the US into Mexico has greatly increased since the pandemic as seen in Exhibit 2.

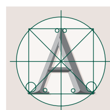
Exhibit 2: New Investment in Mexico from United States (US$M)



Source: Ministry of Economy of Mexico. *Jan-Sep 2023

Secular and Cyclical Tailwinds

It's become clear that a confluence of secular and post-COVID cyclical forces has tilted the investment landscape favorably for well-positioned companies with essential assets in the building materials, aerospace, and railroad industries. The common characteristics that set these leading companies apart from others are twofold. First, they have unique, well-placed, physical assets that they can leverage. Whether an Airbus plane, GE engine, Ryanair flight, or even a CPKC rail network, these assets provide opportunities for capital appreciation and pricing power as supplies are squeezed and demand for these assets rises. Second, these companies are direct beneficiaries of both secular and cyclical tailwinds that support and extend demand for their products and services over the long term. It is these dual tailwinds along with their growing earnings and cash flows that provide a unique opportunity for Andrew and the team to add to the portfolio's resilient growth.



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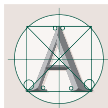
A R T I S A N  P A R T N E R S

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