Research @ Citi Podcast, Episode 16: Tectonic Shifts — The New Era for Industrial Policy

Recorded: November 12, 2024

Published: November 20, 2024

Host: Lucy Baldwin, Head of Research, Citi

Guest: Martin Wilkie, Co-Head, Industrial Tech and Mobility Super-Sector

Transcript:

Lucy Baldwin (00:00)

Welcome to the Research @ Citi podcast. I'm Lucy Baldwin, Global Head of Research at Citi. In each podcast episode, we bring you our thought-leading views and analysis across asset classes, sectors, and economies from around the globe.

Martin, hello and welcome. Thanks for joining us today. You've been an analyst for over 20 years, and you've seen an awful lot of change in your sector in that period of time. Martin, you're Co-Head of our Industrial Tech and Mobility Super-Sector here at Citi. And I'm really excited to be talking to you today about what is changing in the sector globally, particularly after the U.S. election. You and the team, Martin, have been writing for years about decarbonization, digitalization, and automation reshaping the sector globally. But today I want to dig into this in a little bit more detail because, as I understand it, although that's created a lot of winners and losers over time, the shifts that we're seeing now are even more profound, particularly as it pertains to Europe, Martin. Martin, if you can kick us off and just set the scene in terms of the impacts that you're seeing in the sector — and if you think about this almost like an earthquake, Martin, if the epicenter of that quake is Germany, what is Germany seeing now? What is the challenge that that industrial model is facing in 2024 and beyond?

Martin Wilkie (01:31)

Thank you for having me. And, as you pointed out, some of the big themes for the sector have been running for several years and have set up a nice framework for how we think about the sector on decarbonization, on automation and on digitization. But what we have seen even before the pandemic, but certainly accelerating since then, are some tectonic shifts that are really changing how we think about the sector over the next decade or so. Some of these are items like national protectionism. We've seen that already in China, but increasingly the U.S., and to your point on the U.S. election, how tariffs and policy might change as a result of that. Certainly the impact of the Russia–Ukraine war, what that's doing to the defense outlook, what that's doing to energy markets — even the fallout from the pandemic itself has upset how people think about supply chains and how people think about inventory management. And of course, technology disruption, another huge one, AI is obviously the technology that people think about most, but it's not just that, particularly when we think about the automotive industry — it can be electrification and other technology changes. And the final one is the green transition, and within the EU, that's called the Green Deal, but that's really sort of cutting across many of these sectors as well. So when we think about the changes to industry over the next decade or so, those sort of five tectonic shifts, those big changes and how we think about where the economy, where industry is growing is going to have a big impact on corporates and how they think about allocating capital and where they want to grow and where they want to protect their business models.

Lucy Baldwin (03:03)

Martin, that's great. Let's dig into those five each in turn, perhaps. Because as you say, these things that were essentially in many ways sources of tailwinds for Germany and then more broadly for Europe have turned into headwinds, and certainly it's happened at a pace that has meant that for companies and indeed countries, it's very difficult to adapt in a timely manner. Let's start with that first one, this concept of rising protectionism around the world. Could you give us a little bit more context around where we've come from, particularly as it pertains to Europe and Germany's relationship with China to where we might be going here.

Martin Wilkie (03:42)

The China debate and how Germany and Europe react to China is complicated. One of the German government reports from last year talks about China simultaneously being a partner, a competitor, and a systemic rival. So one of the challenges you have is that it's not just a simple debate and a simple resolution to that. We can see that China is a huge source of product into Europe. Certainly when we come to industrial companies, there'll be examples in the solar power industry, for example, where the entirety of that industry in Europe has effectively gone to China. There's other industries which are at the moment very important inside Germany, and of course, the big example there is the automotive industry, but even that one is complex because the German auto industry sells a lot into China as well. So really what is being looked at here is the complexity of this relationship. And of course, it's not just between those two countries, another layer now that's happening with how the U.S. thinks about it and whether tariffs changes that dynamic, and Europe, of course, can't control that. So not only do you have this debate around how Germany and Europe interact with China, but there's also how does it react in a second order way to what's happening inside the U.S. And of course, a lot of these imports from China into Europe have benefited the consumer massively and brought down prices for all sorts of products, whether it's solar panels, consumer electronics, and so forth. But it's not necessarily been good for industry. So Europe has to have a debate within itself as to what to protect. Should it protect the consumer or should it protect the industry and protect the jobs? And that's something that's not been resolved yet. And it's not an easy question to resolve. So in terms of that relationship with China, I think we're still in the very early stages. China itself is, of course, slowing in terms of growth, but as part of that becoming more ambitious in terms of exporting. If the U.S. market becomes even more close to Chinese companies, where do they send that capacity? Do they send it to Europe? In which case, arguably the competitive issues in Europe become even more of a challenge because the Chinese companies are going to be doing less in the U.S. So certainly the reaction to the U.S. election is going to add a new level of complexity to this and it's something that we're still really yet to see where the impact is going to lie.

Lucy Baldwin (05:51)

That's a great set of points, Martin, because as you say, this isn't just about protectionism between any two countries. It's the sort of impact of second and third order effects of global industrial policy. And I guess linked to that, I have to therefore ask you about the IRA and maybe tell us a little bit more about what that really is, and where do you think that goes from a Trump administration perspective?

Martin Wilkie (06:16)

So the Inflation Reduction Act primarily is driving green investments in North America. And so some of that is attracting capital to individual projects to decarbonize parts of the U.S. power sector, but also to incentivize electric vehicles, and some of it was also to put manufacturing into the U.S., so you could get credits for building a factory that makes components that go into many of these industries. So really multiple parts towards that. Now in one sense, it wasn't really truly protectionist, because you as a European company, or even from anywhere else in the world, could open a factory in the U.S. and get these credits. So it didn’t necessarily purely benefit U.S. companies that were quoted in the U.S,. but it really was to attract U.S. assets. So as a European company, I could open a facility into the U.S. and supply the U.S. market. So in that sense, it was seen as a big growth driver. The challenge that you have is that, What does that do in terms of the allocating of capital if you are a European government? Because as a European company, you could put money into the U.S. But that's money that you therefore might not put into Europe. So it was attracting capital arguably away from Europe and into the U.S. So it was good for certain companies, but not necessarily good for Europe overall. Now what's happening now is the debate as to whether or not that act will get repealed or not. Now as we record this, we don't yet know if the House of Representatives is going to be majority held by the Republicans, because to fully repeal that act would require a change of law. It's not clear that all Republicans would support that. In fact, there's a letter from House Representatives in August of this year, saying that the IRA has many benefits, and so we're still working out, is it going to get repealed or not? But even if it remains, it still means that at the margin, companies will be better off putting dollars at work in the U.S. than they are into Europe. So it doesn't mean that Europe is still struggling to get this allocation of capital because the tax credits means that projects in the U.S. are more appealing, so it still remains a challenge for these companies even after the U.S. election.

Lucy Baldwin (08:21)

Fantastic. Very clear. So that was the first of the five tectonic shifts that we're talking about today. The second is the fallout of the Russia–Ukraine War. And in particular, Martin, higher energy costs, defense spending rethink, the U.S. and the Middle East look like the parts of the globe that have a set of advantages, shall we say. How does Europe think about this now in the fallout of the war in Ukraine? Where do we go from here?

Martin Wilkie (08:47)

So I think there's two quite distinct parts to the fallout, as you've highlighted, one on energy and one on defense. Now the energy part of it in the short run is a challenge. You've got energy-intense industries, whether it's in chemicals, whether it's in metals, that are seeing costs that are multiple levels to what you've seen, for example, in the Middle East or the U.S. So at the margin, if I've got a facility in Germany, suddenly my cost of goods sold looks very out of kilter versus what it could look like elsewhere. The German government wants to try and incentivize a move toward greener technologies. And so if the government is able to subsidize that transition so that for chemical facilities for steelmaking and so forth, they can use this upset as a catalyst to change and to decarbonize, it could be a long-run positive, but in the short run, it's clearly a negative at the margin, these facilities are just not as competitive as they can be elsewhere. So how policy reacts to that is going to be crucially important. The risk is that energy-intense industries inside Europe are simply going to miss out on all the allocated capital for future growth simply because of the cost. So really a policy reaction is required there. The second one on defense is arguably the opportunity. Certainly in Germany, defense has been for many companies been seen as a no-go area. There were lots of German Mittelstand companies doing metalworking and so forth, that would, through their own decision, not supply the defense industry, and that's been the case for decades and decades. Now they're seeing one of their customer bases in automotive is becoming less attractive, and secondly that another potential customer base in defense is suddenly attractive and appealing. And so if we do see that ramp up in defense spending, I think you can see companies diversify into defense, and of course, there'll be a question also as to whether we see consolidation in that market as well to build larger European champions inside defense. So from a defense spending perspective, then the defense element could be quite an appeal for growth. Now again, going back to the question on the U.S. election, whether or not that acts as an additional catalyst now to raise spending for NATO countries that are not the U.S. and whether that accelerates even further, I think is something that we'll really now be looking towards over the next couple of years. And arguably defense becomes a better market as a result of this, but energy-intense becomes probably more questionable.

Lucy Baldwin (11:07)

Got it. The third area, Martin, in terms of the tectonic shifts, is this pandemic fallout that continues. So we still see, I think, a number of supply chains around the world being reconfigured. Tell us how the sector is dealing with that and thinking about that and where you see it shifting as we go forward.

Martin Wilkie (11:26)

So we're still very much seeing the fallout from that. There are many industries that we cover that inventory destocking and restocking cycles are still feeling that shockwave from the pandemic, and even once that's resolved, it'll still raise and create the question as to, should we go back to where we were before in terms of just-in-time? I think we can overlay this with the protectionist element as well, because it's not just “Am I able to get these products if there's another global shock?”, but do I want to be reliant on a country that sends these products to me if I can't rely on that country sending them at some point in the future? And of course, you then get the tariff question as well. Will it be more expensive than I think? I would argue that you're going to see this reshoring thesis, which has been a thesis for a long time, but never really actually happened. I think it does, at the margin, make it more likely. What that does then drive is more automation because you need to automate those supply chains, you need to digitize them so you know where the products are, and of course, labor is expensive. So what you don't want to do is bring huge amounts of capacity back to Europe or elsewhere, but suddenly see your labor costs go through the roof. It does mean more technology as well. So we do see this as at the margin, bringing capacity back to Europe, but ultimately in a much more automated way.

Lucy Baldwin (12:44)

And Martin, as you're speaking, it's very evident that all of these themes are heavily intertwined and connected. You can't really look at any one in isolation. The fourth theme that you mentioned at the outset was, of course, technology disruption. Tell us how that's pivoting in a way.

Martin Wilkie (13:00)

I think it has changed. When we looked at the factory of the future a few years ago, it was about connecting factories so that you could benchmark them. And what's happened now with AI is as a capability that was either not known about or underestimated several years ago that has suddenly disrupted how a lot of companies think about the data they have inside factories. Now clearly a lot of these AI tools, whether it's large language models or machine learning, a lot of that capability in a number crunching sense is going to come from enterprise software companies. But when we think about industrial facilities, or even if we think about cars and other machinery products, there's huge amounts of data, whether it's the design or whether it's the actual operating data that's effectively proprietary. And so if I've got a factory that's running, gathering data 24/7, even if I've got a large language model or a machine learning algorithm, I still need to have access to that data, and understand the concept, what does that data mean, before I can really use it in any way. So what we are seeing is industrial companies saying, well, hang on, that data about how this refinery works or how this car company works, that belongs to us — it doesn't belong to enterprise software companies. And therefore, how do you create a moat to make sure that even if these LLMs develop as they will do and get more and more capable and much more complex, there's still the access to data and understanding what the data really means. And this is where we see a lot of industrial companies pushing more into software. So whether it's design software, whether it's productivity software, but to gather and own the software and data. The other big technology change, of course, is around electrification. But this does feed back into some of the themes we've talked about, already — Europe and Germany in particular has been a huge success in the internal combustion engine. If you look at employment in Germany, massively skewed towards automotive, massively skewed towards mechanical engineering, and these industries are changing enormously because of electrification. Simply you need fewer engines, and that means fewer people in those areas. So there has to be a reaction to that as well. And actually benefiting from and using electrification is something that's not going to go away, but the industry needs to react to that because simply the products that you use and the expertise are very, very different.

Lucy Baldwin (15:18)

And that's a nice segue into the fifth tectonic shift, Martin, which of course is the green transition or the EU Green Deal. Many people listening will have thought that Europe was probably winning when it comes to the green transition. Tell us about that, Martin.

Martin Wilkie (15:34)

So I think you're absolutely right. A few years ago, the assumption was that Europe was the winner here. And I would say that from a policy perspective for many years, it was clearly a global leader. But two things have really happened. So one of them which arguably came out of the blue was in 2022 when the Inflation reduction Act was signed in the U.S., because almost overnight, that meant that the policies in the U.S. were more supportive to decarbonization in many industries than the policies were in Europe. I don't necessarily mean in terms of the targets being set, but I mean in terms of the money available to actually implement the technologies. And so suddenly you had these very attractive credits in North America. So on the one hand, there was more money available in the U.S. The other piece of course was what's happening in China where so much capacity was added that reduced the costs in certain industries. This is particularly true in battery electric for cars, but also in the solar industry, and arguably that couldn't have happened elsewhere — the Chinese economy effectively allowed that to happen. So you had two things happening in parallel that really change that concept of Europe as a leader. Now, Europe is still reacting to this. The Net Zero Act, which was outlined a year or so ago, does highlight a number of technologies, about nine technologies that Europe wants to incentivize and to push into further. I still think that that is not fully resolved yet because Europe is having to grapple with these changes that are happening elsewhere. And so how Europe wins from this is still to be resolved. Arguably Europe's made some mistakes, particularly closing down nuclear in a lot of countries. And so those differences of opinion on technologies, including nuclear, have still to be resolved as well. So Europe is still I think in a difficult place. It can still grow in these areas, but it's still not fully resolved as to how it redevelops that leadership position.

Lucy Baldwin (17:20)

Very clear. If I was a CEO, Martin, sat in a boardroom, perhaps in Germany, listening to you talk about these five tectonic shifts, how should I be thinking about my own strategic response?

Martin Wilkie (17:34)

So I think in terms of the diversification globally, if we start there, this is really a hedge against isolationism because if you are a European company only selling into Europe, then you're really at the mercy for a lot of these China policy changes or potentially U.S. tariffs. But of course, owning assets in growing regions can put you on the other side of that fence. So I do think you're going to see European industrial companies looking to buy more assets, particularly in North America to benefit from the growth in that region. And derisking China as well. And we're also seeing this happening already where India in many ways, is going to be the alternative to China, and it's not going to be the same size overnight, but over time, I think you'll see some capital moving from China and incrementally into India. So from that global perspective, that's definitely one we expect to see. In terms of digitization and going back to the point on software and AI, I think whether it's the car industry moving into those areas or whether it's industrials and buying a moat inside AI, that's also what you're going to see. There'll be a blurring of distinction between industrial companies and software companies in many ways. Because again, to create that moat, you need to have access to that data and to that software. That's definitely the second large one we see.

Decarbonization, I think is going to vary a lot from company to company. I think it's existential in the case of automotive and a lot of transport companies because of electrification. In other companies, it may not be quite as big, but I think that'll be more company to company and subsector by subsector as to how they react to that, but they certainly have to react to it if you are overly exposed to these legacy technologies. On defense, again, I think it's going to be very much driven company by company because I don't see companies that are not in defense today, suddenly getting huge inside it. But for those that are exposed to it, I think getting benefits of scale, potentially through consolidation is something that will definitely be a conversational point. And finally, on deconglomeration, the peak of the conglomerate was arguably in the 1990s, and what we have seen is the U.S. has really gone through that deconglomeration phase really since then until now. Europe has been slower. It's definitely been on that track, but I think this accelerates that companies need to shed assets that are not core and to use that to fund this growth elsewhere in things like software and in data. In other parts of the world, it's still very much there, but we're seeing it also in places like Japan as well. So this deconglomeration theme, I think, in many ways, helps fund this transition, and that will also then be I think the fifth argument in terms of how boards think about strategy.

Lucy Baldwin (20:06)

Martin, that's great, and it's very clear that this is going to create a wave of M&A. If you think about the stock market today, what is it telling us? If you look at the national champions, for example, in the U.S. versus the national champions that we have today in Germany, just give us a sense as to the challenge that that starting point poses.

Martin Wilkie (20:26)

So I think in terms of the differences to start with, the most obvious one is certainly geographic. If we look at the quoted industrial sector in the U.S., way over half of their revenues are domestic revenues, so they're benefiting from whatever's happening in the U.S. If we look at European companies, typically the U.S. is 25, 30% or around that. So they're just underweight that fastest growing market. But also Europe is typically massively overweight China. That's a legacy of a lot of the industrial standards in China were born out of European standards, so they had a natural advantage in China. So in some ways, Europe is suffering that the quoted companies are overweight Europe and they're also overweight China. That's something that will change. And so when we think about the companies and how people value them, a lot of that is that geographic mix. And that's why the points I made on reallocating capital is going to be so important to get into these faster growing markets. In terms of where the value accrues, a lot of this depends on how they can capture these deals and integrate them because even though a lot of these digital assets might be in other regions, including the U.S., European companies have incredible amounts of installed bases when we think about assets globally, whether it's infrastructure, whether it's factories, whether it's other industrial processes, and there's a massive value in that installed base. And so getting access to that data, understanding how these facilities run can be of huge value. So in many ways, it's an untapped source of income for European companies at the moment that they have such embedded assets that they can gather data from. So the key here is to make sure that they can get the tools to capture it and they can monetize that data. And I think a lot of what these companies will be doing over the next few years is to make sure they do that.

Lucy Baldwin (22:08)

When you project forward, do you think this scale of transformation that we've been talking about today can really cement Europe's leadership position within this sector? How do you view that?

Martin Wilkie (22:18)

I think Europe has a good track record of benefiting globally, and it's got a good track record of adapting to change. When we look at the U.S., it has gone through its own industrial challenges over the last 20 or 30 years. But I would say that Europe has invested for the longer term and many European companies have taken a much longer view in terms of how they succeed in these areas. And I think a lot of that today will now be where they allocate capital in places like India, even if it doesn't necessarily drive your earnings today or tomorrow, but can you build and help develop the infrastructure markets like that? So I'm hopeful that European companies can and continue to use this expertise. But also, when we look at digitization, the digitization of industrial assets has actually been led by Europe, even though the tech sector has clearly been led by the U.S. So I think there's still areas where Europe at the moment, still has a bit of a lead, but of course, we have to make sure they continue to use that lead. And of course, in parallel, there are some areas that are getting much more challenging, in particular combustion engines. So it's really about managing this transition. And the most important thing is that companies have their eyes wide open and they can see the areas that are in decline and they can grab the opportunities for growth and that includes through acquisitions.

Lucy Baldwin (23:32)

Absolutely. Martin, it's been fascinating listening to you today. Thank you for your time and for your insights. It's going to be a period of continued unprecedented change in the sector. Thank you for your expertise in helping us navigate through that today.

Martin Wilkie (23:46)

Thank you. It’s been a pleasure to be here.

Lucy Baldwin (23:49)

Thanks for joining today's episode of Research @ Citi. We at Citi Research provide the highest-quality products, services and content covering all major asset classes and economies around the world. If you enjoyed this podcast, you can follow us for regular episodes. And feel free to share, like, leave a comment, and subscribe. See you next time.

[Disclaimer] (24:14)