WELLINGTON MANAGEMENT®

Global Industry Analyst Spotlight Series

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Asian Industrials/Automation

ANALYST IN THE SPOTLIGHT

Victor Cherian

As a global industry analyst (GIA), Victor is responsible for identifying investment opportunities in the Asian industrials sector, with a focus on automation and electronic materials. He is also responsible for managing sub-portfolios in our analyst-managed research products, which combine the expertise of our GIAs across industries. Victor is based in our Singapore office.

KEY POINTS

- While the broad investment thesis for automation is well understood, we focus on finding bottom-up opportunities in specific subsectors with high technological barriers to entry and structural growth potential.
- We believe that the market penetration opportunity beyond the traditional mainstay customer industries (autos and electronics) is huge and imminent and that this theme will grow much faster than the broader industrial sector globally for a prolonged period.
- While recent strength has driven up valuations in automation stocks, we think the market is underestimating the likely level of structural demand growth and continue to find attractive ideas globally in this sector.

We believe our GIAs — specialist stock pickers for whom industry research is a career path — are one of Wellington's key differentiators. Their role is to use fundamental analysis to identify investment opportunities for clients' portfolios. It is our belief that stock selection based on in-depth knowledge of an industry has the potential to generate strong investment performance over the long term.

INTRODUCING OUR ANALYST

How did you come to be an industrials/automation analyst?

After a bachelor's degree in Electronics Engineering, I briefly went into the software industry. But I decided to switch career paths, did an MBA and moved into buy-side research, where I covered a wide range of sectors over 17 years and managed sector-focused portfolios. I worked briefly with a hedge fund but soon realised that my investment approach was more suited to longer-term alpha opportunities, as opposed to short-term idea generation. Wellington's investment platform, where GIAs are encouraged to spend time on finding structural opportunities, attracted me to the firm. I joined as the GIA covering Asian industrials in 2011. The focus on automation and electronic materials takes me back to my roots in engineering school, and I am glad to put some of my engineering knowledge base to work!

What in particular attracted you to Wellington?

The beauty of the role here is that it allows me to be opportunistic across a wide range of sub-segments of the industry — and, more importantly, to take a really long-term view. I would also highlight the collaboration, particularly across asset classes. Being able to leverage our excellent team of credit analysts, derivatives strategists and colleagues from the private equity team has given us a significant edge in a number of situations.

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INDUSTRY OF FOCUS: ASIAN INDUSTRIALS/AUTOMATION

There is currently a lot of media attention on automation. Do you share that enthusiasm?

The developments in the automation sector are interesting, but what really excites me as an investor is that the market seems to be underestimating the potential strength and duration of the current cycle. Many analysts use a traditional industrial cyclical framework when looking at automation and build some sort of mean reversion into their investment thinking. So they look at the stock valuations and say: “They are high relative to history; there’s got to be mean reversion.” But our view is built on what other GIAs are seeing in their sectors bottom up. And the unequivocal view, based on our colleagues covering sectors such as e-commerce, pharmaceuticals and consumer discretionary, is that demand for automation will be less cyclical and more structural.

In the current environment of central-bank liquidity and low global growth, we tend to see capital chasing the few secular growth opportunities. If we can find sub-sectors of the market where demand growth looks more structural, the winners in those sectors should be able to hold — and more likely improve their multiples over time.

So you disagree with many analysts’ concerns about the sector’s valuation?

I admit that some stocks have rallied pretty hard recently. But I continue to see value in these stocks and we are using any sell-offs driven by valuation concerns as an opportunity to buy strategically for the long term. We believe that automation, like the broader tech sector, is in the early stages of a very exciting structural growth story which the market continues to underestimate. The answer lies partly in your conviction on the duration of the cycle. The market’s concern about valuation is driven more by near-term estimates. But, looking at it through our lens that this is a longer-term opportunity, I still find valuations pretty attractive.

You mentioned that some specific sub-sectors are of interest to you. Where do you see the greatest opportunity?

Automation is a broad sector, and we believe that several sub-segments are rapidly getting commoditised. So I spend a lot of my time working out which sub-sectors have the highest technological barriers to entry. I also look for quality management teams, whose drive for innovation should help them to stay ahead of the competition.

Based on our bottom-up analysis, we focus on a few themes which dominate our automation portfolio construction. For example, we have been spending a lot of time recently on areas like machine vision and cobots. Most analysts appreciate that demand will grow in these areas, but we have a differentiated view on the duration and magnitude of that growth. The machine vision industry is growing at an annual rate of 10% – 15%, but the market expects that growth rate to fade over the next two to three years. We disagree. There is an explosion of innovation in this area, and the number of applications has been increasing exponentially across a broad range of industries.

Similarly, for cobots, the current market size of 30,000 units pales into insignificance relative to what we believe could be more than 1 million units in a few years. While traditional robots have to be caged for safety reasons and hence move within a defined perimeter, a cobot will have the flexibility to work in a normal human environment. This has been enabled by rapid advances in fields like machine vision and sensor technology.

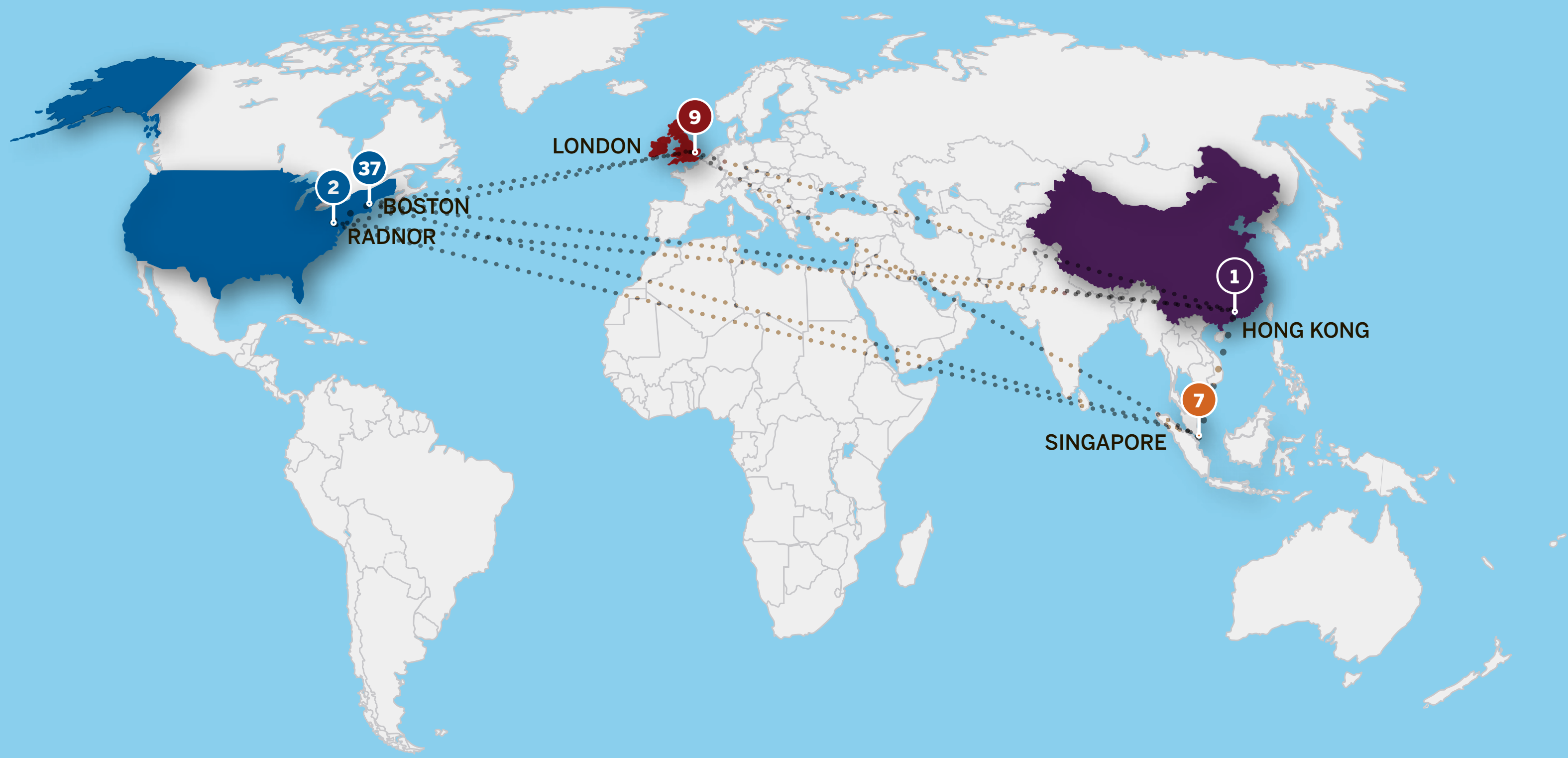
What is distinctive about the way you play machine vision?

We spend a lot of time looking for stocks in this area. Surprisingly few investors expect machine vision to be a structural winner, and those few mainly buy the big-cap stocks in the US and Japan. Our approach is to spend time at industry trade shows and factory floors trying to discern new and credible applications for machine vision and then figure out from companies who provides their vision solutions. That approach has led us away from the large caps to some very interesting small-cap names in Asia and Europe. Many are barely covered by analysts. Some of our best ideas have come from observing subtle but important changes in production lines through repeated factory floor visits over a number of years.

Any other particular reasons to be positive on the sector?

We see a highly dynamic industry, with bold mergers and acquisitions as well as private companies looking towards initial public offerings. This is fertile ground for finding new investment ideas. Also China has made no secret that it intends to dominate the industry. Yet there are major barriers to entry in some sub-sectors. The Chinese have hitherto had little success in developing their own indigenous robotics technology in a number of domains. So they have started to acquire assets in different parts of the value chain. A couple of years ago, a Chinese company bought a large European robot maker, and another big industrial company is starting to build a warehouse automation platform through M&A. I believe this deal-making momentum will accelerate, and several of the smaller-cap companies are likely acquisition targets.

AN INTERCONNECTED GLOBAL TEAM OF INDUSTRY SPECIALISTS



Number of global industry analysts as at June 2017

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