

Industrial Sector Perspectives: Finding Opportunity Amid Supply Chain, Labor Uncertainty

**Jeff Burgis**

Partner, Primary
Investments

Nolan Pauker

Principal, Private Credit

Craig Waslin

Partner, Co-Investments

KEY TAKEAWAYS

- While overall demand for industrial products and services remains strong, supply chain disruption and labor shortages are raising costs and limiting companies' ability to meet demand.
- Some manufacturers are showing increasing desire to reduce their reliance on offshore production.
- Automation and technology are increasingly important for industrial companies to mitigate rising labor costs and achieve growth.
- Areas with apparent tailwinds include e-commerce, electrification, localized supply chains, automation, commercial space, and decarbonization.
- Credit and equity investment opportunities exist in resilient sectors for select companies with the ability to pass on higher input costs without negatively affecting demand.

Between forced closures, subsequent supply chain disruption, labor shortages and whipsawing demand, many industrial companies were impacted by the COVID pandemic, which is why understanding current market dynamics, including key trends in specific subsectors, is critical to making well-informed investment decisions.

Up-to-date data and research, including perspectives gathered through conversations with GPs, helps Adams Street to assess risk and to identify managers with the strategies, skillsets and expertise we believe are needed to succeed in this environment. These insights, coupled with company specific diligence, help us to evaluate opportunities across our primary, co-investment and private credit strategies.

Disruption early in the pandemic led to divergent performance across industrial subsectors.¹ For example, building products and automotive saw strong demand, while aerospace struggled as air travel effectively ceased.

As COVID restrictions eased, demand rebounded strongly across many industrial subsectors. Currently, corporate profit margins are at the highest level since 1950,² underpinned by healthy balance sheets and excess consumer savings built up during the pandemic.

While the overall outlook for industrial demand remains generally positive, supply chain disruption and labor shortages are raising costs and limiting the ability of some companies to meet that demand. More uncertainty has also been created by Russia's invasion of Ukraine, which has caused energy, metals, and grain prices to surge.

While there has been improvement in some areas affected by supply chain strain, significant product backlogs continue in sectors such as building products and automotive.

Reshoring & Automation

Concern about supply chain disruption, coupled with uncertainty around tariff and trade negotiations, is accelerating the desire of some industrial companies to reshore manufacturing capacity. This longer-term trend may be most significant for US companies that have outsourced significant portions of their production overseas, for example, those that rely on semiconductor fabricators in South Korea and Taiwan.

Labor shortages are also accelerating the adoption of Industry 4.0, which refers to how industrial companies are using automation, connectivity, machine learning, and real-time data to enhance manufacturing processes and supply chain efficiency. There is significant opportunity for mature, labor-intensive industrial companies to leverage technology and software to help automate their businesses.

Growth in automation is illustrated through increased robot deployment in recent years. According to the International Federation of Robotics, the installed base of robots grew 13% annually from 2015-2020 to a level that exceeded 3 million units in 2021.³

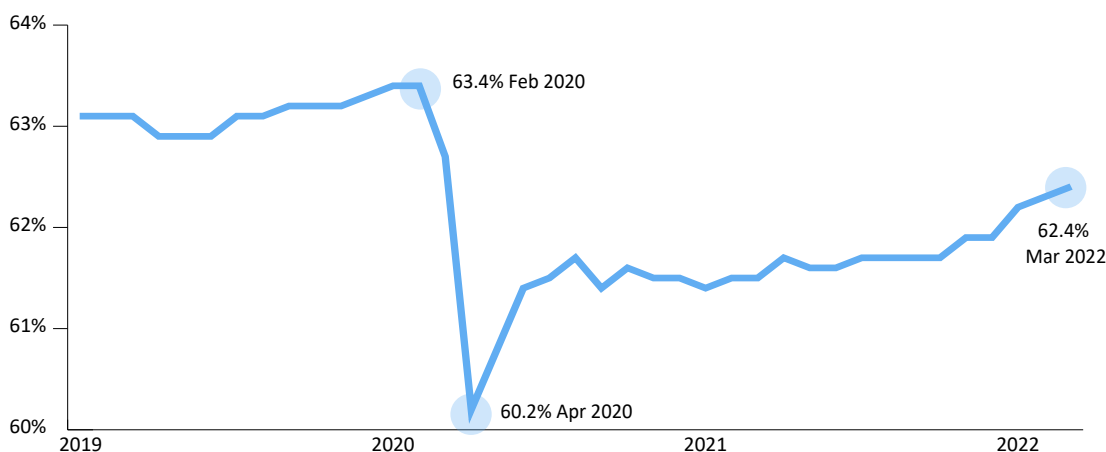


Labor shortages are also accelerating the adoption of Industry 4.0, which refers to how industrial companies are using automation, connectivity, machine learning, and real-time data to enhance manufacturing processes and supply chain efficiency

Talent War

Compared with supply chain disruption, the labor shortage may be a longer-term issue, due in part to an aging US workforce that is causing the gap to widen between jobs that need to be filled and the qualifying talent pool capable of filling them. In addition, labor force participation continues to lag pre-Covid levels as people opt for early retirement, take career breaks, or start their own ventures.

Figure 1: U.S. Labor Force Participation Rate (Jan 2019 - March 2022)⁴



The difficulty US companies are facing in finding workers to fill vacancies is creating a “war for talent,” a further challenge for manufacturers, where working conditions can be less appealing to job seekers. Several GPs noted that certain smaller companies may have difficulty attracting and retaining workers if they are subscale and lack the resources to implement technology and automate.



Tailwinds and Headwinds

Within the broad industrials universe, we see tailwinds in areas including e-commerce, electrification, localized supply chains, automation, commercial space, and decarbonization. We believe businesses that embrace sustainability are likely to benefit from increasing adoption of environmental, social and governance (ESG) metrics.

We also see growth opportunities with companies that can leverage technology and automation in the production or distribution of highly engineered products and services that are difficult to replicate. These companies often enjoy higher growth and better margin profiles because of competitive barriers to entry.

In terms of fiscal stimulus, certain subsectors may benefit from the passage of a \$1.2 trillion infrastructure bill in November 2021, and we could see the \$1.75 trillion “Build Back Better” bill resurface in some form, which could be expected to provide a boost for sectors such as electric vehicles and renewable energy.

We believe that more challenging areas with headwinds include smaller manufacturers that lack a technology advantage, companies with little pricing power and a high reliance on labor, commodity-exposed enterprises, and businesses on the wrong side of ESG.



We also see growth opportunities with companies that can leverage technology and automation in the production or distribution of highly engineered products

Key Diligence Considerations

When it comes to assessing private equity investments, certain issues are especially important in the current environment. These include the ability of a company to attract and keep talent; whether it can reduce its reliance on labor through automation; how much leeway it has to pass on higher input costs without hurting demand; whether it sells into an end-market with growth tailwinds; and whether it operates on the right side of ESG.

It’s also important to determine if demand for goods is temporarily inflated. In many cases, the pandemic increased demand for goods as people – unable to travel or pursue other leisure activities at the height of the crisis – spent on items such as their houses, cars, Peloton bikes, etc. As expenditure on services rebounds, demand for products may wane. In some cases, we believe this uncertain picture is leading companies to hold back on investing in capacity until a more normalized picture emerges.

Private Credit Perspectives

When it comes to private credit, our outlook for industrial companies remains positive. When evaluating industrial investments in the current environment, we have become focused on understanding the nuanced impacts of supply chain disruption and labor shortages. A few examples include:

- **A company's ability to access supply of materials and manage materials pricing.** We have seen many instances of companies failing to access adequate supply, or suppliers calling "force majeure" and not honoring contracted prices because of production issues or raw material shortages.
- **Availability of labor across a company's value chain.** We have seen companies become impacted by labor constraints at suppliers or customers. As a result, even when a company is able to manage its own workforce well, its top line can be negatively affected by factors outside its control.
- **Assessing stable end customer demand.** For certain goods and services, supply chain and labor pressures have resulted in price increases of 10% or more to the end consumer. We place considerable emphasis on ensuring that end customer demand stays strong and can withstand these increases.
- **Real-time financial updates.** We increasingly emphasize flash financials and real time updates, as the impact of supply chain and wage pressures will take time to roll through LTM financials and covenant calculations. These timely data inputs help us to identify and triage potential performance impacts as soon as we can.



In our view, companies with the best potential have the scale to attract and retain top talent, and the ability to use technology and automation to take share from competitors and achieve growth

Equity Co-Investment Perspectives

As a starting point, attractive co-investments within the industrial sector require both a management team that is able to navigate ever-changing dynamics, and experienced, high-quality private equity lead sponsorship.

We seek out market leaders who provide differentiated products or services in large and growing end markets that we believe are recession resilient. We also look for companies that demonstrate they have robust business models, sustainable revenue growth, strong margins, and solid free cash flow.

Packaging is one area where we believe demand and company performance should remain strong — or even accelerate — because of recent dislocations. We believe growth in e-commerce and automation within the production process have helped drive demand and margin expansion in the sector.

Demand growth is also significant for companies on the right side of ESG, such as those that supply flexible, reusable packaging using recycled materials.

In addition, we have industrial companies in our co-investment portfolio that are benefiting from the adoption of warehouse automation and tailwinds in growing end markets, such as the Internet of Things, robotic surgery equipment, and scarce electronic components.

Summary

While industrial demand is strong, labor and supply chain constraints continue to drive up input costs. Our focus is on finding managers and companies that we believe can resist these trends and benefit from the tailwinds. In our view, companies with the best potential have the scale to attract and retain top talent, and the ability to use technology and automation to take share from competitors and achieve growth. ■



1. The industrials sector encompasses a broad range of subsectors, including building products, automotive, transportation, aerospace and defense, and chemicals. Because companies within these subsectors sell into and operate in different end markets, it is difficult to make generalizations across the industrials sector as a whole.
2. Sources: Bloomberg BusinessWeek March 22, 2022; Bureau of Economic Analysis News Release March 30, 2022 "Gross Domestic Product (Third Estimate), Corporate Profits, and GDP by Industry, Fourth Quarter and Year 2021"
3. IFR World Robotics 2021 report October 28, 2021
4. Source: U.S. Bureau of Labor Statistics



LEADING WITH FORESIGHT™

Adams Street Partners is a global private markets investment manager with investments in more than thirty countries across five continents. The firm is 100% employee-owned and has over \$51 billion in assets under management. Adams Street strives to generate actionable investment insights across market cycles by drawing on 50 years of private markets experience, proprietary intelligence, and trusted relationships. Adams Street has offices in Austin, Beijing, Boston, Chicago, London, Menlo Park, Munich, New York, Seoul, Singapore, and Tokyo. adamsstreetpartners.com

Important Considerations: This information (the "Paper") is provided for educational purposes only and is not investment advice or an offer or sale of any security or investment product or investment advice. Offerings are made only pursuant to a private offering memorandum containing important information. Statements in this Paper are made as of the date of this Paper unless stated otherwise, and there is no implication that the information contained herein is correct as of any time subsequent to such date. All information has been obtained from sources believed to be reliable and current, but accuracy cannot be guaranteed. References herein to specific sectors are not to be considered a recommendation or solicitation for any such sector. **Past performance is not a guarantee of future results.** Projections or forward-looking statements contained in the Paper are only estimates of future results or events that are based upon assumptions made at the time such projections or statements were developed or made. There can be no assurance that the results set forth in the projections or the events predicted will be attained, and actual results may be significantly different from the projections. Also, general economic factors, which are not predictable, can have a material impact on the reliability of projections or forward-looking statements.