Emerging Markets: Stock in Focus

Techtronic Industries

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This article has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Global Emerging Markets Fund.

Techtronic is the world's leading tools company, with a portfolio of brands that includes Milwaukee, Ryobi, AEG, Vax and Hoover. The company is listed and headquartered in Hong Kong, with production spread across emerging markets and the US. Company revenue has increased by an average +13% p.a. since the GFC and net profit growth is even more impressive at +26% p.a. over the same period. The stock has increased some +620% before dividends since it first entered the Northcape Global Emerging Markets strategy in 2014 and is currently one of our and the Warakirri Global Emerging Markets Fund's larger positions.

In a nutshell, the tools industry has undergone more change in the past decade than the previous fifty years and we believe Techtronic is the main beneficiary of this change. In this feature piece we outline our investment thesis, highlighting why the company has done so well, but more importantly explaining why it is so well positioned for many more years of very sturdy growth.

Techtronic Brands

In the pro tool segment, brand authenticity and heritage are important. Professionals use tools to generate income and hence need tools which are reliable and safe. This makes them risk averse in purchasing, preferring long-established brands which have a track record of producing safe, reliable tools. As a consequence, all of the leading tool brands have a long (a hundred years, on average) history, as shown below.

Brand Heritage Matters in the Pro Segment

Age of Top 10 US Tool Market Brands

		Brand Heritage
1	Dewalt	79 years
2	Milwaulkee	91 years
3	Black & Decker	105 years
4	Stanley	172 years
5	Ryobi	72 years
6	Bosch	129 years
7	Emerson	125 years
8	Makita	100 years
9	Irwin	130 years
10	Empire	96 years

Source: Northcape Analysis

Key Industry Feature	Implications
1. Safety is important	Manufacturers with a long track record of producing safe, reliable tools have a significant advantange over new entrants.
2. Most power tools come with an extended warranty	The warranty of given by an established player is likely to be valued more highly by consumers than that given by new, untested entrants
3. In hand tools, reliability is critical	High quality hand tools may last 10+ years and are used by professionals who derive their income from using the tools. Hence reliability is a key driver of the purchase decision.
4. Tools are a very small part of total construction costs	Pricing is less important than the above criteria, and as such price competition is ineffective. This creates a further barrier to new entrants.

Source: Northcape Analysis

This creates a barrier to entry for new entrants and a competitive advantage, or "economic moat" as Warren Buffett would say, for established players. Private label or cheaper Chinese brands are virtually non-existent in the pro segment of power tools.

Until about ten years ago the predominant dynamic was "best in class" where each category was dominated by a different leading brand. For example, Makita might be the leading player in nail guns, whereas Stanley Black & Decker was the main player in drills. The leader in each category shifted over time amongst the main players as new, products came to market. As a consequence, a typical tradesperson owned a mix of the leading brands: some Makita, some DeWalt (Stanley Black & Decker's pro brand), some Milwaukee.

This dynamic changed forever with the arrival of lithium-ion (Li-ion) rechargeable tools, and the management of Techtronic deserves full credit for being the first player to understand the game changing, highly disruptive implication of this technological shift.

Li-ion battery tools are cleaner, safer and more efficient than traditional corded or gas (petrol) powered tools (this will be discussed in more detail later), but the biggest impact the technology change has for the industry is to create a network effect and a first mover advantage.

Li-ion tools are designed to be interoperable using the same battery, with batteries and tools are sold separately. Batteries are costly (for example the Milwaukee 18V 12.0Ah battery retails for A$250) but are long life and can be charged and recharged many times. The exhibit below provides a snapshot of the Milwaukee M18 tool system; all of these tools work with the same interoperable 18V battery.

Milwaukee M18 Tool Range; 100+ Tools, One Interoperable 18V Battery

Imagine a tradie has three Milwaukee M18 tools and a M18 battery. When the tradesperson needs to buy a new tool – an angle grinder, say – he or she has two choices:

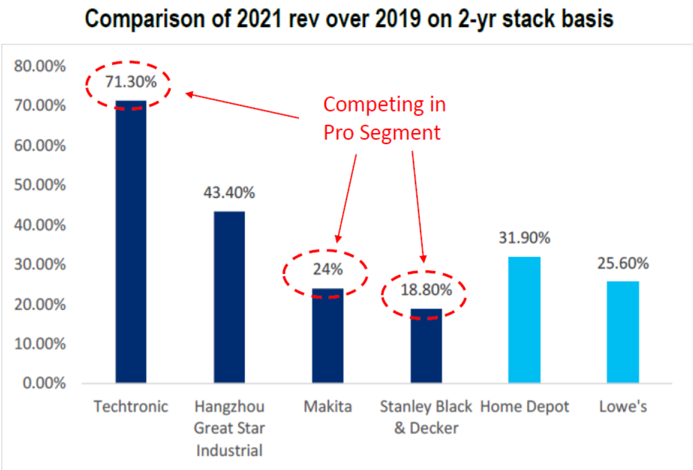
1. buy a Milwaukee angle grinder, or
2. buy a DeWalt or Makita tool and the corresponding Li-ion battery for that tool.

The non-Milwaukee option is immediately a couple of hundred dollars more costly since it requires an additional battery purchase. As such, the tradesperson will almost certainly buy another Milwaukee tool – it is costly to leave the network. This is true even if the competitor tool is judged to be moderately better (it's unlikely to be better enough to justify the cost and inconvenience of a whole new battery system).

This is exactly what we see from market data from the pro segment: Milwaukee users rarely purchase tools from competitors, and the more Milwaukee tools and batteries they own, the less likely they are to leave the brand when they make additional tool purchases.

Hence the tools industry has shifted from "best in class" to a potential "winner takes all", with the advantage accruing to the first mover, which is Techtronic. The chart below shows that over the past two years in particular, Techtronic's revenue growth has significantly exceeded that of its peers in the pro segment.

1H19 – 1H21 Revenue Growth Comparison
Leading Tool Brands



Source: Citi Research, Company Reports

Why was Techtronic ahead of the curve in recognising and leading the shift to Li-Ion rechargeable tools? We think it was a consequence of three factors: ownership, manufacturing philosophy and R&D focus.

Ownership - unlike Stanley Black & Decker, Techtronic's founding family – including the current Chairman and also the Chief Operating Officer – own some twenty percent of the company. One of the Eight Principles which guides the Emerging Markets investment process is "alignment of management and shareholders' interests"; Techtronic is a great example: there is a single class of shares, executive pay is modest compared to peers and management have large shareholdings.

One way this has benefited shareholders is acquisitions: whilst Stanley Black & Decker's professional management have a history of overpaying for other businesses, Techtronic has consistently shown wonderful discipline and strategic focus.

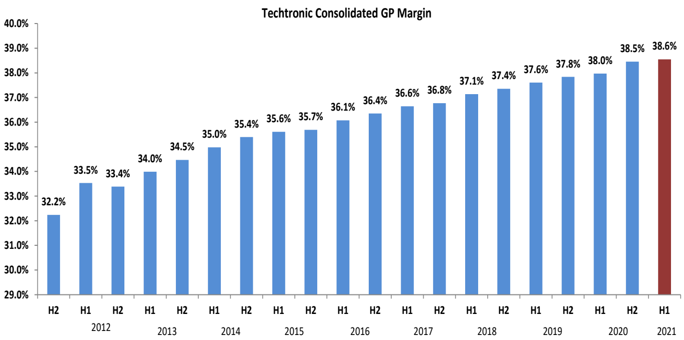
Another is time horizon: Techtronic's management team – as owners – are 'in it for the long haul'. This has resulted in the company's management performing better in positioning Techtronic for multiyear structural industry changes, such as the shift to Li-ion rechargeable tools.

Manufacturing philosophy - unlike peers which have outsourced most production to OEMs, Techtronic retains a large in-house manufacturing footprint. For example, the company is the only major player to produce all electric motors in-house, which proved to be a major advantage in speed-to-market of Li-ion rechargeable tools. Both the CEO and Chairman often emphasise that "manufacturing is in the company's DNA"; indeed, the company started life as an OEM manufacturer in China and Hong Kong for Western tool companies, before meticulously building its own exceptional brand portfolio through careful and well-timed acquisitions.

Whilst the company does outsource some lower value elements of the production process (and notably also the manufacture of Li-ion batteries, which requires specialist know-how), a great deal of manufacturing IP remains within Techtronic. The faster production cycle enabled through in-house manufacturing has helped the company quickly adapt to, and indeed front-run, major industry changes.

R&D focus - just as manufacturing is "in Techtronic's DNA", so is Research & Development. The company has a great track record of gross margin improvement, much of which has been reinvested back into R&D. The company is on track to spend roughly US$440m on R&D this year alone, a higher proportion of revenue than peers. In 2020 Techtronic added 1,200 employees, with nearly one third of this amount new, highly qualified engineers for its R&D department. Also important is the focus and efficiency of R&D spend unlike peers, Techtronic has no legacy corded or gas tools – 100% of R&D spend is focused on Li-ion rechargeable tools.

Techtronic Gross Margin Progression



Source: Company Financial Statements, Northcape Analysis

The final piece of the puzzle is to understand why the world is shifting from corded and gas tools to rechargeable electric ones, particularly in the pro segment. Gas (petrol) tools billow smoke and get very hot during prolonged use. This is a major OH&S issue in poorly ventilated job sites due to lung damage from breathing particulates and fire, and injury risk arising from hot tools. Upgrading to Li-ion rechargeable tools brings an additional environmental benefit as the grid shifts away from fossil fuels to renewable sources of electricity generation.

Corded tools also present an OH&S nightmare due to the risk of tripping in crowded building sites and the risks around temporary power points. Both gas and corded tools typically require much more space than their Li-ion equivalent – as the exhibit below neatly shows in the case of a pneumatic nail gun.

Li-ion tools require much less space and ancillary equipment than legacy tools

Source: Company presentation

The benefits of Li-ion tools are so clear that the shift from legacy technologies is becoming mandatory in some areas. For example, the state of California recently announced that gas-powered outdoor tools will be prohibited from 2024. As usual, California is a pioneer, and we expect other regions to follow. Recent improvements in Li-ion battery technology have enabled a whole range of electrical tools which were previously technologically impossible, including ride-on lawnmowers and heavy-duty jackhammers.

The range of Li-ion rechargeable tools is expanding rapidly as battery technology improves

The application of Techtronic's proprietary motor and battery system to an ever-increasing range of industries, including most recently professional landscaping, should underpin solid double digit revenue growth in coming years.

Investors continue to underappreciate the network effect arising from the transition to Li-ion rechargeable tools, resulting in Techtronic still trading on a discount to our assessed intrinsic value. These factors, combined with positive ESG characteristics of cleaner tools, underpin a compelling investment case for the company to continue to generate significant shareholder value.

Techtronic Industries epitomises the kind of companies we own in the Emerging Markets strategy. Specifically, in terms of common themes from the bottom-up, we continue to covet companies with strong ESG scores, high returns on capital and little or no debt, such as Techtronic.

We also want to own companies that are well placed to make opportunistic, yet sensible acquisitions from distressed sellers, from which they will create greater shareholder value over the years ahead. Or alternatively, pay more cash back to shareholders.

By way of example, Techtronic has taken opportunities in its history to buy high quality assets at very favourable prices, with the most notable example being the acquisition of the Milwaukee and AEG tool brands in 2005, which it acquired for US$626 million – just 1x revenue.