Background
Rockwell Automation Inc ROK

Rockwell focuses on core as end markets prove volatile.

byKeith Schoonmaker, CFA
Sector Director
Authors can be reached at Analyst Feedback
Morningstar's Editorial Policies

Analyst Note 01/28/2015
Rockwell Automation began fiscal 2015 with modest 2% year-over-year growth in underlying sales, despite coming into the first quarter with a lower-than-expected backlog and book/bill ratio. Consolidated revenue reached $1.6 billion, as Rockwell's architecture and software segment reported solid organic revenue growth of 5.1%. In contrast, the control products and solutions segment only managed to hold segment revenue flat on an organic basis, as weak service sales largely offset growth in product revenue. However, services book/bill began to rebuild in the quarter, providing a sign that segment sales should improve over coming quarters. Improved operating leverage and productivity gains in A&S, along with favorable business mix in CP&S despite weaker sales, resulted in 140 basis points of year-over-year consolidated margin expansion to 22% in the quarter. We've adjusted our near-term assumptions to reflect management's updated 2015 guidance; however, our long-term thesis for wide-moat Rockwell Automation remains intact. As such, we reiterate our fair value estimate of $108 per share.

Management appears to be taking a wait-and-see approach with respect to its oil and gas business, which represents about 12% of Rockwell's consolidated sales. While the exposure is fairly limited, it skews more toward upstream applications, which could be hardest hit should customers accelerate capital expenditure budget cuts. In an environment in which there is a shift from exploration activities, such as drilling, toward maximizing the efficiency of existing oil wells, Rockwell's suite of automation products and services may yet experience stable demand. Even if this assumption does not hold, we believe Rockwell's well-diversified portfolio can withstand this near-term challenge.

Investment Thesis 08/13/2013
As the largest pure play in the automation and controls segment, Rockwell benefits from meaningful switching costs as well as an ability to invest cash flow back into the enterprise without supporting other corporate growth initiatives. Setting Rockwell apart from the pack is the firm's deep domain knowledge, which starts with concentrating on its customers' industries. For instance, by matching a customer in the food and beverage industry with an engineer that has spent a career providing machines to the food and beverage industry, Rockwell is able to better target customer needs and prove the value that it has to offer.

Rockwell’s open source architecture is distinct in the industry and allows applications to sit on top of competitors' and allow a customer to make incremental upgrades to its factory automation software, as opposed to doing an extensive overhaul. Strategically, Rockwell is able to develop a connection at a lower cost to the customer, and forge a relationship so that when a complete overhaul is necessary, the firm is in a stronger negotiating position than it otherwise would have been. Further insulating itself from the risks associated with being a pure-play firm, Rockwell has sought to diversify its revenue base geographically. Increased geographic diversity has dampened the cyclical swings in the firm's earnings; however, it has also required Rockwell to compete more closely with European domiciled competitors.

Rockwell management decided to invest more than a billion dollars into the Logix platform throughout the past decade, with the aspiration of being able to move from traditional discrete automation and controls to being able to integrate multidisciplinary controls into one architecture. This move has proven wise, as the firm now has a presence across the manufacturing plant floor. This technology has also allowed Rockwell to venture slowly outside of its niche in manufacturing plants and move to mining, refineries, and food and beverage plants. While growth will not be as easy going forward for Rockwell, as competitors have their eyes open, we think the company has a comfortable growth path ahead.

Economic Moat 08/13/2013
Rockwell's wide economic moat is based on the high customer switching costs in its Logix automation control platform. Installing an automation platform often involves moving many critical processes onto a central control system. The initial growing pains are similar to implementing a new enterprise reporting platform across a large company. With many parts of the system talking to each other, the opportunity for error is large, and the costs of mistakes are higher. As such, many companies elect to stay with the incumbent product for several years rather than convert to something new, irrespective of the technology improvement. The long 20- to 30-year life span of control systems gives us confidence that Rockwell's returns on invested capital will be protected from outside threats. But the same force that Rockwell benefits from also inhibits organic growth, a critical factor in explaining the decade-long progression toward building a presence in process automation--a new platform for Rockwell. To the extent that Rockwell is able to unseat incumbents and bundle in more equipment, high switching costs support the economic moat.

Valuation 11/17/2014
Our fair value estimate is $108 per share, which implies forward price/earnings of about 16 times. During the next five years, we assume that organic revenue will increase at an average rate of 6.5%. By 2019, we expect long-run operating margins of nearly 16.5%. Under these assumptions, Rockwell should generate strong average returns on invested

capital of 24.7%, comfortably exceeding its 10% cost of capital. We assume effective tax rates will reach approximately 27% in arriving at our fair value estimate.

Risk 08/13/2013
We assign a medium uncertainty rating to Rockwell Automation as uncertainty surrounding the economic cycle is offset, to some degree, by long-standing customer relationships and a diversified set of end market applications for Rockwell’s core products. Revenue growth remains a key source of risk to our cash flow projections as Rockwell’s product demand is linked to capital spending cycles. Additionally, Rockwell’s ability to continue to command a reasonable premium in the marketplace remains important to our cash flow analysis. Rockwell’s ability to generate strong free cash flows also presents a capital allocation risk as the firm has a number of potential investment opportunities and may elect to use accumulated cash to pursue low-return investments. While this stands as an overall risk, it is important to note that management’s philosophy to-date has been to return available free cash flow to shareholders.

Management 12/07/2012
Keith Nosbusch took over the CEO title in 2004 and became chairman in 2005. Nosbusch began his career with Rockwell subsidiary Allen-Bradley. Nosbusch was one of the key players in Rockwell's successful development of Logix, the company's marquee automation system. He heads a 10-member board, eight of whom are independent. Ted Crandall was named CFO in October 2007. Crandall has had a long career with Rockwell; he served as senior vice president of Control Products and Solutions between 2004 and 2007. We're impressed by the manner in which senior management runs the company in general and its focus on long-term value creation specifically. We applaud the company's decision to sell its power systems division in order to more efficiently allocate capital and enhance shareholder value. The company's governance policies are solid. Board members do have some skin in the game (though not an overwhelming amount), and management's annual cash incentives include a return on capital component. Annual bonuses are based on revenue, earnings per share, free cash flow, and pretax return on invested capital.

Under the current management team's guidance Rockwell has moved away from purely being a discrete controls component business, to become a respectable competitor in multidisciplinary controls, lifting shareholder returns in the process. In the early part of the decade, Rockwell made the strategic decision to invest in technology that would allow it to not only provide more value to existing customers, but to also extend the company's reach into new markets. By nature, manufacturing processes are very sensitive to customers, resulting in high switching costs for incumbents. During the last decade, Rockwell's approach has helped widen and deepen the company's moat while arguably chipping away at the moat of sleeping giants Emerson, Honeywell, and Siemens.

Shareholders own a more competitively advantaged company today than they did 10 years ago. In our opinion, that was largely due to the decision-making of the leadership team, leading to our exemplary stewardship rating.

Overview

Profile:

Rockwell produces industrial process-control equipment designed to make factory floors more efficient. It makes products that control, measure, and monitor processes ranging from beverage production to heavy-equipment manufacturing. Products include motor starters, signaling devices, relays, sensors, and motors. Rockwell's most recognized brand is Allen-Bradley in controllers.

--

Bulls Say

- By selling the power systems business, Rockwell has been able to refocus its manufacturing, marketing, and distribution efforts to factory automation. The net result has been an improvement in margins.
- Rockwell's balance sheet is loaded with cash, and strong cash flow generation makes the firm an attractive acquisition target for a strategic buyer.
- During the past three years, Rockwell has distributed more than 85% of its available free cash flow to shareholders via dividends and share repurchases.

Bears Say

- While manufacturers come back to their factories, it is difficult to project when those companies will begin upgrading technology and needing Rockwell's services.
- Growth in Asia has slowed considerably since its peak, potentially reducing the growth available to Rockwell.
- Although margins are higher in automation and controls, Rockwell is now competing against very large firms that can easily outspend it in R&D, potentially eroding the company's technology advantage.

More...

Competitors

ROK

Name	Price	% Chg	TTM Sales $ mil
Rockwell Automation Inc	**$112.18**	**-1.19**	**6,606**
General Electric Co	$27.10	-0.07	148,589
Siemens AG ADR	$108.45	-2.39	78,979
Siemens AG	$110.25	0.11	78,979
Honeywell International Inc	$101.84	-1.09	39,840
3M Co	$156.49	-1.12	31,821

--

From VIC

ABB LTD ABB

January 14, 2015 by

buggs1815

			2015	2016
Price:	19.50	EPS	1.46	1.75
Shares Out. (in M):	2,304	P/E	13.3	11.1
Market Cap (in M):	44,928	P/FCF	13.3	11.2
Net Debt (in M):	1,654	EBIT	4,786	5,268
TEV:	46	TEV/EBIT	9.7	8.5

Submit an idea for full membership consideration and get access to the latest member ideas.

- Description / Catalyst

- Messages (0)

Description

Investment Thesis: ABB is well positioned to succeed in its two main lines of business: power (40% of revs) and factory automation (60% of revs), and both markets will show substantial growth in coming years. The current valuation represents an attractive entry point for a quality business with a clean balance sheet and good long-term growth prospects.

Company Overview

Zurich-based ABB Ltd. is a global leader in power infrastructure equipment and factory automation. I believe the company is a strong player in its two key markets and is quite cheap for such a quality company. The long-term outlook for ABB's markets is quite favorable, even though the recent stock price action suggests otherwise.

The company operates in five segments:

1. Discrete Automation and Motion: Includes drives, motors, inverters, robots and most equipment for general industrial automation. ~22% of revs/~28% of EBITDA
2. Low Voltage Products: Includes switchgears, breakers, control products, wiring accessories or numerous other products designed to protect electronics, improve efficiency, and increase safety for primarily industrial use. ~17% of revs/~23% of EBITDA
3. Process Automation: Sells equipment designed primarily to automated specific industrial processes in industries such as oil & gas, mining, chemicals, paper & pulp, and marine. ~19% of revs/~17% of EBITDA
4. Power Products: Sells a wide range of products such as breakers, transformers, capacitors and surge arrestors to utilities to aid in generation, transmission, and distribution. ~24% of revs/~25% of EBITDA
5. Power Systems: Provides turnkey solutions to utilities for power generation, grid systems, substations, and network management. These projects include design, engineering, supply, installation and testing. ~18% of revs/~7% of EBITDA

The company was formed from a merger between Swedish Asea AG and Swiss BBC Brown Boveri AG in 1988, but Asea traces its roots back to 1883. ABB is a true multinational with 34% of revenue coming from Europe, 29% from the Americas, 27% from Asia, and 10% from Middle East/Africa.

Power

The power grids in the developed world are old and decrepit according to numerous sources. In addition the growth of "non-base load" renewable energy is putting new strain on energy transmission and distribution systems. See:

United States:

http://www.infrastructurereportcard.org/a/documents/Energy.pdf (2013) ASCE gives U.S. electric infrastructure a D+

http://www.asce.org/uploadedFiles/Issues_and_Advocacy/Our_Initiatives/Infrastructure/Content_Pieces/failure-to-act-electricity-report.pdf This is a more detailed look at the U.S. electric infrastructure from ASCE

http://www.ferc.gov/industries/electric/indus-act/transmission-grid.pdf (From 2002, so a bit dated)

"There is growing evidence that the U.S. transmission system is in urgent need of modernization."

http://congestion09.anl.gov/documents/docs/congestion_study_2009.pdf (from 2009)

Highlights the key areas of congestion in the U.S. grid.

Europe:

https://www.entsoe.eu/publications/position-papers/position-papers-archive/Pages/Position%20Papers/Fostering-Electricity-Transmission-Investments-to-Achieve-Europe%C2%B4s-Energy-Goals-towards-a-Future-Looking-Regulation.aspx

"To meet EU energy and climate goals, major investments in the electricity transmission infrastructure are necessary. This investment challenge, however, is unprecedented in size and pace and means a significant financing challenge"

http://ec.europa.eu/energy/mff/facility/doc/2012/connecting-europe.pdf

"The EU's energy infrastructure is ageing and, in its current state, not suited to match future demand for energy, to ensure security of supply or to support large-scale deployment of energy from renewable sources. The upgrading of existing, and development of new energy transmission infrastructures of European importance, will require investments of about EUR 140 billion in electricity and at least EUR 70 billion in gas."

While developed world governments and utilities have been slow to spend on electrical improvements so far (very little in the way of fiscal stimulus has been forthcoming), in the coming years such spending will be a necessity that cannot be avoided. We also believe that fiscal spending on electric infrastructure financed with low interest debt is a good investment for most countries.

The emerging markets are working hard to provide electricity to their citizens, yet according to the IEA (http://www.worldenergyoutlook.org/resources/energydevelopment/accesstoelectricity/) over 1 billion people globally have no access to power. Almost every economy has come to depend on consistent power supplies thanks to the rising importance of PCs and electronics generally. Emerging economies have a significant need to spend on power infrastructure.

In terms of recent performance, ABB's power products business has been healthy while its power systems business has been under-earning due to poor performance on a number of large projects which management is trying to address.

Factory Automation

Factory automation should only increase in the future. For instance, ABB has already replaced human drivers in certain mining applications in Australia and done an entirely automated mine in Brazil. As the cost of labor rises in places such as China, the opportunities to replace labor with smart automation increase. You don't need to read the detailed report mentioned below to see the punch line that factory automation is a significant growth industry (8%+ CAGR forecasted 2013 through 2018):

http://www.prnewswire.com/news-releases/225b-smart-factory-market-automation-analysis-and-2018-forecasts-279319442.html

With humans having a variety of health cost, reliability/fatigue, and safety issues, it is no wonder that companies are replacing manual labor with automation when they can. Sure the downturn in mining has had a negative impact as mining is a great industry to replace human labor with automation (mostly for safety reasons), but almost every manufacturing industry sees good benefits from automation.

The recent performance of the factory automation business has been lackluster as it has been weighed down by a drop in revenue as miners and commodity producers tone down their capital spending. I expect this headwind to continue for a few years, but not indefinitely. Order trends have recently perked up in these lines of business with orders up 55% y/y in Q3 for process automation and 12% y/y for discrete automation and motion.

Competition

There is no question about it, both the power business and the factory automation business are competitive businesses. One should expect them to remain competitive, but ABB has established a solid position in almost all its markets. ABB strives to have #1 or #2 market share in each of their specific sub markets. ABB has #1 market share globally in the following markets: transmission & distribution, distributed control systems, gearless mill drives for mining, industrial motion (motors & drives), electric propulsion for ships, terminal automation for ports, and large industrial turbo chargers.
In power ABB competes with Eaton Corporation, Legrand, Mitsubishi, Schneider, Siemens, Leviton, Rittal, Hyundai, Hyosung, Crompton Greaves, Larsen & Toubro and Bharat Heavy Electricals, Alstom, Emerson, General Electric, Prysmian and Nexans.
In automation ABB competes with Alstom, Fanuc Robotics, Kuka Robot Group, Rockwell Automation, Schneider, Siemens, Yaskawa, SMA, WEG Industries, Emerson, Honeywell, Invensys, Metso Automation, Voith, and Yokogawa Electric Corporation.

Valuation

ABB's valuation is, simply put, undemanding.

The stock trades at 13.3x 2015 EPS estimates of $1.46. On an EV/EBITDA basis the stock similarly appears reasonably cheap at 7.9x '15 EBITDA estimates. The company threw off FCF of over $3.05 billion in the LTM, implying a healthy 6.6% FCF yield on a TTM basis and it should be ~ 7.5% FCF yield for 2015. These valuations seem reasonable for a business that has consistently generated ROICs north of 15% (although this has been pressured closer to 10% recently by near-term challenges in the power systems business).

I can easily imagine this business being worth 15 or 16x EPS and growing EPS at a 10% CAGR for the next several years. Indeed the comapny's EPS growth targets for 2015-2020 are a 10-15% CAGR. It is not hard to imagine this as a $30+ stock in a few years.

Capital Allocation

Capital allocation is fairly shareholder friendly. The company pays an approximately 3.5% dividend annually. In addition the company committed in September to buying back $4 billion of stock over the next two years, a move which should be quite accretive to remaining shareholders at current prices. It works out to a buyback of roughly 9% of the company at current prices. This is not a company that is hoarding excess capital to the detriment of shareholders.

Activist Target?

Another interesting idea is whether ABB may one day become an activist target. It seems to me that there is little logical reason to keep the automation and power businesses together under one roof. While they may share some overlapping industrial customers, separate incentives for the power and automation management teams would probably help drive results. The investment thesis doesn't bank on it, but I would imagine that ABB could become an activist target if its valuation and performance don't improve under the new management team which came in during fall of 2013.

Conclusion

ABB is a true multinational with a strong position in the global power and factory automation markets. It has a clean balance sheet, shareholder-friendly capital allocation policy, boasts high returns on capital, and sports a reasonable valuation. It should make an excellent long-term investment.

<u>Risks</u>:

- Fiscal spending on infrastructure projects has been tight for years. Perhaps Europe or the U.S. will be willing to try fiscal stimulus as it becomes clear that growth is less than desired, but there are certainly no guarantees.
- ABB serves many industrial businesses and is, thus, subject to economic cycles. (e.g. ABB serves mining and commodities businesses which have been reducing capital spending recently.)
- ABB has faced a few years of struggling to drive growth and particularly margins. New management seems to have a realistic plan to get things growing and margins expanding again, but time will tell if they execute as promised.
- Acquisitions are part of the ABB game plan. If they acquire too aggressively, it may stretch the balance sheet. Management seems to have been prudent so far, but it merits watching.

- The energy industry is changing with the rise in solar, natural gas, etc. and decline in things like coal. ABB's power business should be well positioned to benefit from the change, but if certain customers' balance sheets become threatened (e.g. coal-driven utilities) as a result of the changes, it could also cause problems.

I do not hold a position with the issuer such as employment, directorship, or consultancy.

I and/or others I advise hold a material investment in the issuer's securities.

Catalyst

There a number of potential catalysts for ABB.

1) I think if the ECB finally delivers on QE, that will be good for ABB stock, because even though it is a multinational it is largely percieved as a "European" company.

2) If management makes meaningful progress on improving power systems profitability which has been depressing earnings, the street will likely come around to the name quickly.

3) Could an activist agitate to split the company up? Maybe.