

Upgrade Cycle

Even the best industrial-equipment suppliers have, at best, bored the market to tears in recent years. Abhay Deshpande argues why such malaise isn't warranted for venerable Emerson Electric. By Ted Crawford

The market hasn't been a particularly hospitable place for one-time industrial darlings like Emerson Electric. Apart from investors' penchant for the new and shiny, companies like Emerson – which dominates mundane markets for things like air-conditioner compressors, garbage-disposal units, and control valves and measurement instrumentation for the oil-and-gas and chemical industries – have been buffeted by weak energy prices, tepid growth in developing and emerging markets and a strong U.S. dollar. Over the past two years its operating profits have fallen nearly 25%, while its shares, as high as \$70 at the end of 2013, now trade around \$52.70.

That spells opportunity to Abhay Deshpande, who recently launched Centerstone Investors after 15 years at First Eagle Investment Management. "We don't mind cyclical, as long as the balance sheet can endure the cycle and the business is inherently well insulated from competition," he says. Emerson's leading market shares in many of its primary markets offer significant scale cost advantages, he says, while the typical 20-to-40-year lifespans of its equipment limit opportunities for new competitors.

He also values that the 120-year-old Emerson has continued to evolve its business from a pure product company to one more focused on vertically integrated services. This evolution, supported by a direct sales force, a global network of over 200 service centers and a large number of co-location contracts with customers, has driven a five-plus percentage point increase in gross margins over the last 20 years, to better than 40%. Product sales are typically part of a package that

includes maintenance, repair and overhaul services that now account for 30% of Emerson's total revenues. Given the company's \$84 billion global installed-equipment base, he expects that goose to continue laying golden eggs for many

years to come.

Because the market is overly fixated on concerns about the current operating environment, Deshpande believes it isn't recognizing the continued improvement in the quality of Emerson's earnings. The

INVESTMENT SNAPSHOT

Emerson Electric

(NYSE: EMR)

Business: Global manufacturer of monitoring, control, power and automation systems for industrial and commercial end markets.

Share Information (@9/28/16):

Price	52.69
52-Week Range	41.25 – 56.82
Dividend Yield	3.7%
Market Cap	\$33.91 billion

Financials (TTM):

Revenue	\$20.58 billion
Operating Profit Margin	15.8%
Net Profit Margin	9.0%

Valuation Metrics

(@9/28/16):

	EMR	S&P 500
P/E (TTM)	18.7	24.8
Forward P/E (Est.)	17.9	18.4

Largest Institutional Owners

(@6/30/16):

Company	% Owned
Vanguard Group	6.2%
State Street Corp	4.6%
BlackRock	4.4%

Short Interest (as of 9/15/16):

Shares Short/Float	3.3%
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EMR PRICE HISTORY



THE BOTTOM LINE

Abhay Deshpande believes the market's cyclical concerns are obscuring the continued improvement in the quality of the company's earnings. Conservatively assuming no cyclical improvement, on his estimate of normalized EBIT he values the shares at around \$65.

Sources: Company reports, other publicly available information

August sale of its commoditized power-supply business, for example, improves pro-forma operating margins from 15% to 18%, and takes pro-forma returns on capital from 18% to 28%. The deal also further bolsters the company's balance sheet, shrinking its net-debt-to-EBITDA

ratio to just 0.6x.

Based on the durability of its franchises, Deshpande believes the shares should trade for at least 15x normalized EBIT rather than today's 11x on depressed trailing numbers. That would put the shares at \$65, with greater appreciation potential as

Emerson's end markets recover. While he waits, he sees protection on the downside from management's decision to return all free cash flow for the time being to shareholders, generating an effective yield on today's share price of roughly 6%. Maybe boring can be beautiful after all. **vii**



Centerstone Investors is a New York-based, investment management firm founded and led by Chief Investment Officer, Abhay Deshpande. Centerstone is an investment advisor registered with the US Securities and Exchange Commission. Launched to provide our clients with a nimble and flexible, value-oriented investment approach offering niche investment vehicles. We are heavily focused on the fundamental analysis of businesses. The Firm is privately owned and we pride ourselves on our 100% employee ownership culture, creating alignment with our investors.

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