Vermeer Global Fund – Infrastructure Spending

VERMEER INVESTMENT MANAGEMENT

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As we move towards the end of the year, US politics will likely move back to the front of the news cycle. It is often said that nothing increases politicians' decision making faster than an upcoming holiday, and with the Thanksgiving and Christmas holiday periods shortly upon us, there are several key items that the White House would like to tick off its check list. After the passage of the infrastructure bill, discussed in more detail below, items such as approving the recently renominated Jerome Powell for a second term as Federal Reserve Chair, reconciliation and the constant recurring issue of the US debt ceiling will all be headline news items over the final few weeks of 2021.

Given that a special infrastructure spending package has been mooted in the US for decades, we thought that the well overdue action recently taken in what is unfortunately now a very rare case of bipartisan cooperation, provided a good opportunity to discuss the topic in more detail. President Biden signed the $1.2trillion bill into law last week. The bill totalled around $550billion in actual new spending, with the balance coming from a 5-year re-authorisation of the existing highway bill which included a 30% increase in spending over the prior version. The bill provides federal funds for spending on "hard" infrastructure across the US with, amongst many items, $110billion for roads and bridges and $66billion for passenger and freight rail. Recently, the American Society of Civil Engineers gave a C- grade on the state of US infrastructure, with some individual states receiving a much lower grade. On a slightly more positive note, the report stated that 2021 was the first time in 20 years that US infrastructure was graded at C-, having been D+ rated in 2017. One of the reasons for the upgrade was that companies and state governments were now learning what is required to make communities climate resilient and able to deal with more extreme weather.

Infrastructure has been a running theme within the portfolio since the launch of the Fund and we have played this via several different angles. This ranges from mining and construction chemicals companies, to the more niche areas such as water.

Within the American Society of Civil Engineers report referenced earlier, it was noted that in the US, there is a water main break every two minutes, leading to an estimated 6 billion gallons of treated water lost in the US each day, enough to fill over 9,000 swimming pools! This type of statistic is the reason water has been a theme within the portfolio. In 2020, we took profits in water infrastructure leader Xylem, and following several quarters of poor execution we felt the valuation was now too stretched for its fundamental performance. We rotated the capital into Evoqua Water Technologies, a trade that has been beneficial to overall fund performance. We had been monitoring Evoqua since the business was IPO'd back in 2017 but having been listed by private equity, it took the company a very long period of time to deal with its exceptionally high debt levels, leading to years of share price underperformance. Following several meetings with the company, we recognised that the management team had become far more disciplined and focused on fixing its balance sheet, and after taking the necessary action we felt the company was now in a position to grow and benefit from the incredibly attractive end markets that it operates in.

The US infrastructure bill provided $55billion for clean water, likely to be dispersed over a five-year period. Along with its wastewater business, the market has been paying attention to the opportunity

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presented to companies such as Evoqua from targeted spending to deal with water contaminants such as PFAS, for which the infrastructure bill allocated $4billion directly. PFAS is a toxic chemical that over many years has led to ground and water contamination. We believe that Evoqua is likely to benefit from a significant portion of this spending aimed at reducing the levels of PFAS found in water along with the more structural themes of wastewater and outsourced water. The company reported a very solid set of results this month, highlighting the issues discussed above along with the strong underlying structural growth in its end markets.

Elsewhere in infrastructure, we long held a position in the aggregates company Vulcan Materials, but following our strict sell discipline, despite the positive macro backdrop and good execution, the stock had become too expensive for the earnings it was likely to produce under even the most positive scenario. Based on this, we decided to take profits. We continue to believe that this area remains an incredibly attractive long term investment opportunity, with the lack of investment by governments in infrastructure not just a US issue, but a global problem. We have a position in European construction chemicals company Sika and within emerging markets, we are playing this theme via Shree Cement, the high-quality Indian cement manufacturer. Furthermore, we recently took new position in construction equipment company Caterpillar.

We initiated a position in Caterpillar following a pull back in the shares and a good set of quarterly results. The company is exposed to structural tailwinds that allow us to play many different themes through one company. Many of Caterpillar's clients have held back on capex spending for many years, such as mining and rail companies and when combined with a positive macro backdrop and record low dealer inventories, we think this provides an attractive set up for the company over the next several years. These same clients will also be looking to upgrade their equipment to more environmentally friendly versions as they each look at ways to achieve their own sustainability targets, whilst a continuing shift towards autonomous machines provides a longer-term growth runway. Along with this, the company will benefit from the infrastructure bill, with research indicating that around a third of Caterpillar's revenues can benefit either directly or indirectly from the bill. Caterpillar has a very strong balance sheet and a good dividend yield of just over 2%, recently continuing its 27-year track record of increasing its dividend annually and has been an excellent allocator of capital historically. With the stock trading on around 16.5x 2022 earnings, compared to a stock like Vulcan mentioned earlier that now trades on over 30x, we believe the stock is attractively valued given the investment case.

There remains a significant need to invest in infrastructure. We believe it is one of the last remaining areas where government spending can provide real economic growth and job creation which leads to a strong multiplier effect within economies. The passage of the US bill is a key step, and we hope to see similar packages passed in countries such as India, the UK and Japan and will continue to look to find ideas where we can invest to play to this.

Finally, the passage of the infrastructure bill is just the first of many steps that President Biden needs to take to try and improve his very poor polling. Biden is currently only polling at 35% amongst independents whilst only President Trump has had lower approval ratings than Biden at this stage in a Presidency. We are now only twelve months away from the midterm elections in the US, where history suggests that the Democrats will lose control of the House whilst having a better shot at maintaining control of the Senate given a more favourable map this election cycle. The Democratic party likely know that this is a once in a generation opportunity to get a lot of their agenda signed into law and will need to try and get both the moderate and progressive wings of their party on the same page to have plenty of action points that they will be able to campaign on during the elections next year.

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