

We have lift off

Sometimes, when looking for attractive investment ideas, it is easy to get caught up in seeking new and exciting technologies which promise to change the world. Often overlooked are those companies which provide a product or service which are key to life, operate in the background and are only really noticed when they fail.

For example, prior to Covid, how many times did you think about the elevators in your office building? Most likely, the times you paid most attention were the times they failed, that time you had to walk up six flights of stairs to get to your desk. Lifts and escalators are essential parts of the smooth functioning, not only of office life, but also airports, retail malls, and London's underground network. The list goes on.

Otis Worldwide Corporation (Otis) is a company which manufactures escalators, elevators and moving walkways, and also provides after-market services such as repair, maintenance and modernisation. Otis was spun out of United Technologies in March 2020, having originally been acquired by the company in 1976. Company founder Elisha Otis invented the safety elevator, which automatically came to a halt if the hoisting rope broke. We originally owned shares in United Technologies, recognising the potential for value realisation as the conglomerate discount was unlocked through the spin off. Pure-play elevator companies trade at substantially higher valuations than the other parts of United Technologies business. After the spin-off we continued to hold shares in Otis.

The elevator and escalator industry is a highly consolidated one; Otis is the largest of five main players which together control 70% of the market. Otis has roughly 18% market share, with the next largest players, Kone and Schindler, each controlling around 15% of the market. The low cost of an elevator relative to the cost of building construction and compared to its critical nature for the functioning of the building, not to mention the safety issues, means that contractors tend to rely on well known, tried and tested brands, providing barriers to entry for new firms.

Around 80% of Otis' profits are generated from after-market services such as maintenance and repair. The recurring nature of this part of the business smooths earnings and so has historically made these companies more stable than others in the buildings sector. The nature of providing maintenance and repair services is that it benefits from route density. Minimising unpaid travel time between that of paid work is key to maximising profitability. Since escalators and elevators are largely needed in more densely packed urban areas, this gives a good starting point. However, this can be further improved through having a greater number of installed units in any one area. Otis has over two million elevator units under maintenance agreements. Engineers can easily travel from one job to another and can be located close by for any emergency requests. Better service can be provided with shorter wait times for engineers, increasing the likelihood that customers choose to switch providers. Otis has a 93% maintenance contract retention rate. In this business, scale matters, which has driven market consolidation. ►►

Broadly, growth in the industry is driven by macroeconomic trends such as urbanisation and increasing wealth of developing nations. In general, as cities get wealthier, buildings get taller, and citizens less inclined to walk up multiple flights of stairs to their office or apartment. Building modernisation cycles also drive growth of new equipment sales. In addition, the spin-off appears to have unlocked a new level of incentivisation for management with a new offensive strategy regarding market share being announced. The service industry represents the easiest and most attractive target, as smaller independents make up a larger portion of the market (around 50%) and offer the opportunity for significant cost synergies.

Despite not having the best economic conditions to start as a standalone company, and with the March 2020 listing coming as developed market economies began to lock down, Otis's share price has increased by over 75% since then. The shares have re-rated from trading on c.22x P/E to around 27x. Despite this, they still trade at a discount to peers Kone and Schindler.

Spin-offs remain one of the few market anomalies which have been shown to outperform over the long term. Combined with attractive industry dynamics and strong financials, including best in class free cash flow conversion, this makes for a tempting investment opportunity. Sometimes long-term winners are best found in boring, overlooked places. ■

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