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New Tailwinds for North American Manufacturing… and Private Equity Investors

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COVID highlighted the need to strengthen supply chains and interrupted a decade-long recovery in U.S. manufacturing. Newly emerging tailwinds present an opportunity for investors. The road towards reshoring will be complex and long, but tailwinds present an opportunity for buyout managers with the rare, required skills. GroveStreet can help investors access the opportunity through a variety of approaches.

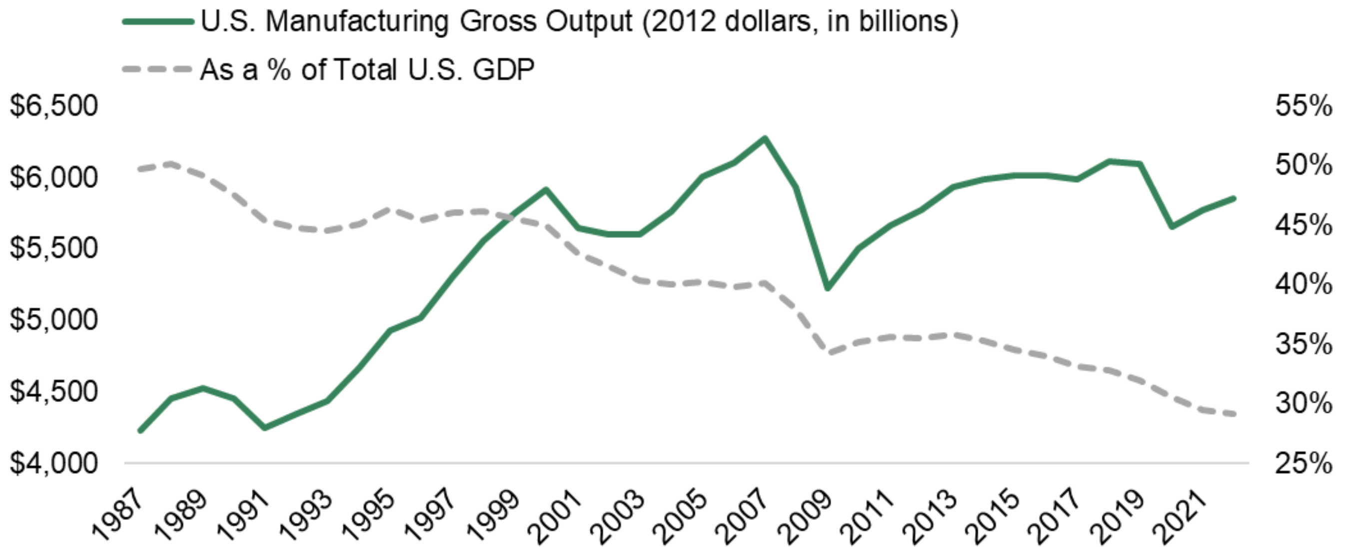
COVID highlighted the need to strengthen supply chains…

COVID disrupted global supply chains with immediate impact close to home. Consumers stockpiled toilet paper and bid above list price for new vehicles while factories stood idle or underutilized, unable to source parts from high-end semiconductors to the most basic components. Even hospitals ran short of critical supplies. Still recovering three years later, supply chains have been further strained by Russia's invasion of Ukraine as well as broader current and potential future geopolitical tensions. Not surprisingly, reshoring and nearshoring initiatives are priorities for many businesses.

… and also interrupted a decade-long recovery in U.S. manufacturing.

While declines in U.S. industrial employment from 1987 to 2017 dominated headlines and mindshare, real *manufacturing output actually increased over 40%* during the period. To be fair, manufacturing has not grown *as fast* as the rest of the economy, but output nonetheless increased, particularly in durable goods such as computer products and motor vehicle parts. Exhibit I presents these respective trends. While hardly steady, the trend is clear. Inflation-adjusted U.S. manufacturing gross output experienced two decades of growth leading up to 2007, plunged during the GFC, and then returned to consistent low single digit growth from late 2008 to 2019. Recently U.S. manufacturing gross output has returned to a positive trajectory after the COVID-related shock.

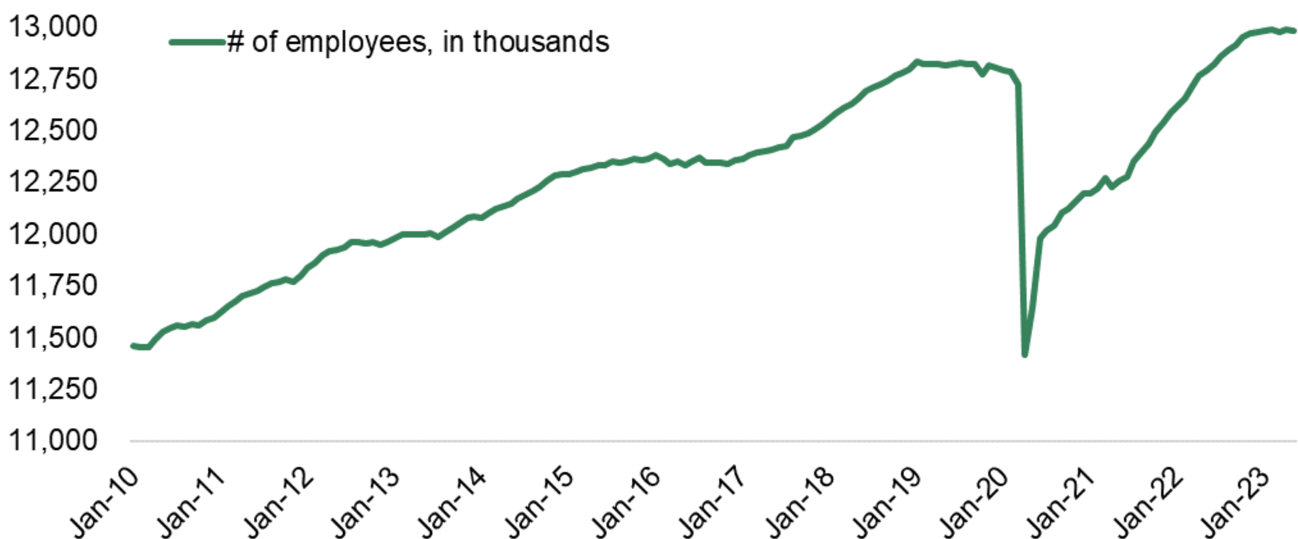
Exhibit I: Real U.S. Manufacturing Gross Output



Source: U.S. Bureau of Economic Analysis

This trend can also be observed in the manufacturing industry's consistent increase in non-farm payrolls since 2010, which was only briefly interrupted by COVID and has been back on a positive trajectory since mid-2020.

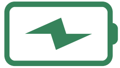
Exhibit II: Non-Farm Manufacturing Payrolls



Source: U.S. Bureau of Labor Statistics

New tailwinds present an opportunity for investors.

North American manufacturing is not for the faint of heart and well-known challenges persist. U.S. manufacturers struggle to find qualified workers at home and face relentless cost pressures from cheap labor overseas where environmental regulations and workforce protections are not as onerous. That said, a new set of forces has begun to emerge in the last decade and continues to gain traction, increasingly offsetting these well-known challenges:



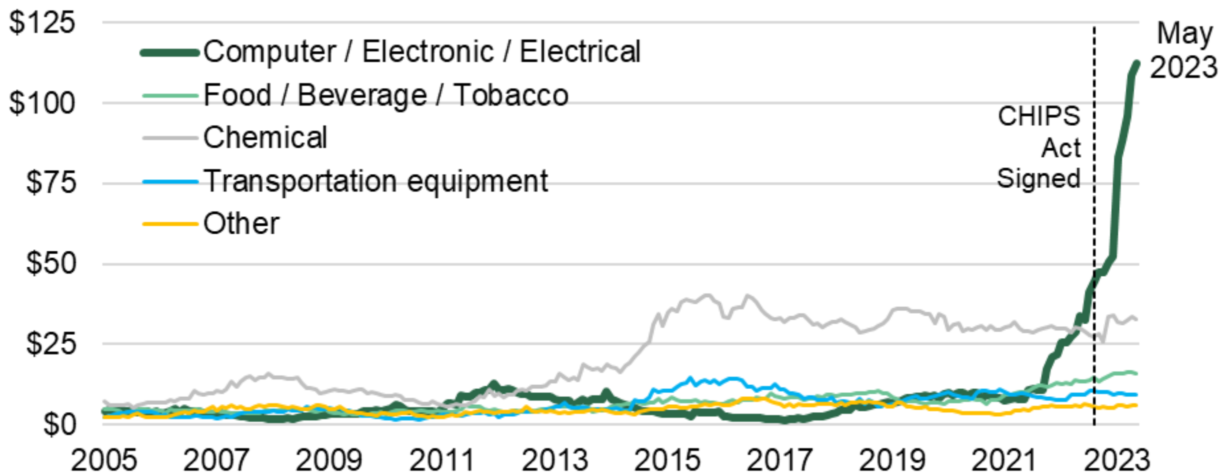
The robust energy complex: The U.S. increasingly enjoys a broad energy portfolio that is reliable and cost competitive relative to other parts of the world. Advances in renewable energy paired with new technological options to access traditional fossil fuels have changed the calculus for industries assessing domestic production versus overseas production plus shipping. While energy prices have come off peak levels, they remain relatively high globally and have made the U.S. more competitive across energy dependent industries. And the benefits are not just on the input side – with renewable-energy capacity expected to increase fourfold by 2050[1], there are new manufacturing opportunities as demand for next generation power equipment is set to increase.

Technological advances: U.S. manufacturers, together with their neighboring peers in Canada and Mexico, are poised to take a meaningful leap forward with the current wave of industrial technology. 49% of business leaders have invested in advanced analytics for supply chain planning, accelerating these plans in the last few years to mitigate the impact of geopolitical uncertainty. Annual investment in artificial intelligence (AI) has reached roughly $150B across sectors, and investors are pouring $250B into the Internet of Things (IoT) every year. The installed base for advanced robotics is also growing as companies take advantage of smarter, more flexible, and more cost-effective equipment.[1] Advances in robotics have led to machinery that is gentle enough to pick up cherry tomatoes from a conveyor belt without damage, flexible enough to be re-configured by workers on the shop floor with a smart pad, and interactive enough to replace workers moving in random horizontal and vertical paths across a warehouse. Combined with a steepening global cost curve, these technological advances have made the U.S. significantly more cost competitive and have already led to more investment focus on certain domestic manufacturing industries.

[1] https://www.mckinsey.com/capabilities/operations/our-insights/delivering-the-us-manufacturing-renaissance

Geopolitical tensions: Geopolitical conflicts and risks are driving initiatives to secure domestic sources for strategic inputs and are spurring demand for all U.S.-based manufacturing, especially defense. U.S. dominance in the global weapons trade increased notably over the past five years. Russia, meanwhile, will likely play a smaller role in the global arms trade because its weapons are needed for the war, sanctions are reducing demand, and Russian defense equipment has proven sub-par on the battlefield.[2] War in 2023 is not just cyber and air, but old-fashioned ground battles that consume enormous amounts of heavy equipment. While Russia's war is the clearest real-time example, potential future risks such as the possibility of a conflict between China and Taiwan are also driving onshoring. Specifically, the $280B of U.S. chip manufacturing projects established in the CHIPS Act's grew exponentially as the China-Taiwan tensions started heating up.[3] And this may end up becoming a long-term transition as geopolitical issues appear to be escalating.

Exhibit III: US Private Construction Put in Place for Manufacturing by Type ($ Billions)

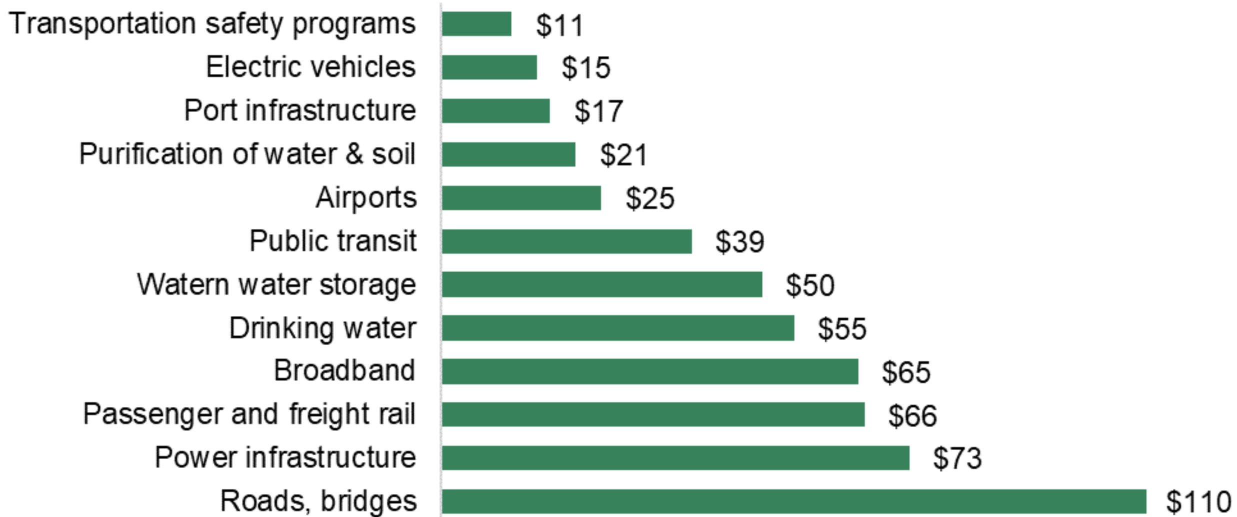


Monthly, at a seasonally adjusted annual rate.
Source: https://www.census.gov/construction/c30/historical_data.html

Federal support: The Infrastructure Investment and Jobs Act and the Inflation Reduction Act of 2022 directed billions of dollars to bolster infrastructure and manufacturing capacity on U.S. soil. Exhibit IV shows the breakdown of federal support from the Infrastructure Investment and Jobs act across different sectors.

[2] https://www.axios.com/2023/03/14/global-arms-sales-us-dominates-russia
[3] https://www.axios.com/2022/08/09/biden-chips-bill-signing

Exhibit IV: Infrastructure Investment and Jobs Act ($ Billions)



Source: https://www.npr.org/2021/11/05/1050012853/the-house-has-passed-the-1-trillion-infrastructure-plan-sending-it-to-bidens-des

The relative cost of manufacturing in the U.S. is beginning to converge with other regions, helping to counteract the low supply and high cost of U.S. workers. Indeed, technological advances have contributed to a 3.6% increase in total factor productivity for U.S. manufacturing in 2021, despite a 5.9% increase in labor compensation.[4] Reshoring for some industries is not only a risk-mitigating step but also profitable.

The road towards reshoring will be complex and long, but tailwinds present an opportunity for buyout managers with the rare, required skills…

It is early innings in the reshoring process, and imports continue to outpace domestic output; after two years of strong growth, higher interest rates threaten a cyclical slowdown. Importantly, few PE firms have remained dedicated to the sector. Those that remain tend to be scrappy value-oriented or distressed specialists with intense operating capability. The relative ease over the last decade in some PE segments such as tech growth have created over-funding, while the grittiness of industrials has created under-funding.

… and GroveStreet can help investors access the opportunity.

For over two decades GroveStreet investors have been rewarded by backing special situation and value-oriented industrial PE teams. Talented GPs have the potential to generate solid returns in this lightly trafficked segment of the PE landscape. GPs can find attractive deals in

[4] https://www.bls.gov/productivity/

distressed, orphaned, and family-owned businesses. They can then build value by executing significant operational improvements, positioning the assets to be attractive to strategic and financial buyers. Teams that GroveStreet has supported have navigated the shocks of the GFC and COVID with impressive outcomes. The distinctive skills and demonstrated track record to take on PE opportunities in manufacturing are rare. Investors that can identify and partner with this select group of GPs with these attributes have an opportunity to take advantage of manufacturing tailwinds in the years to come.

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