alphinity INVESTMENT MANAGEMENT

Otis Elevators (NYSE:OTIS)

Getting a lift from technology

August 2020

Otis Elevators (NYSE:OTIS) was spun out of United Technologies (NYSE:UTX) in April 2020 and we recently added it to the Alphinity Global Equity Fund. Otis is the world's largest elevator and escalator company in an oligopoly alongside Kone and Schindler, its two European listed peers, and Thyssenkrupp (sold to a private equity consortium effective 31 July 2020).

Why we like it

The industry is an attractive one, with tailwinds from middle class expansion, urbanisation and advances in technology. Safety requirements and strict regulation ensure high entry barriers while technological advances in predictive and remote maintenance is increasing the barriers in the service segment. With an existing large installed base of equipment, the need for regular maintenance and modernisation creates regular, defensive and high margin revenue streams for the incumbents.

Otis is the largest player in the industry with a globally balanced portfolio (~1/3 in each of Americas, EMEA and Asia Pacific) and a strong services segment generating ~57% of revenues and ~80% of its operating profits. New equipment sales, while more economically sensitive, is driven by secular trends and share gains in regionally contested emerging markets. Capital reinvestment requirements are low and advanced customer payments benefit working capital, delivering a highly cash generative model.

Covid-19 disrupted the business during recent months as lockdowns and uncertainty impacted revenues (unable to attend buildings or maintenance work deferred, new equipment or modernisation work delayed) but as an essential service these initial constraints are being overcome. Looking ahead, the desire for touchless technology and remote monitoring has risen as a response to the pandemic and should expand the existing opportunity for its products and services. Its China business has already rebounded strongly. With over 50% of elevators in residences, both work from home and increased social distancing trends are likely to drive up elevator usage (service needs) and installs of improved technology in Residential and Commercial settings.

Outlook: a mispriced opportunity

As a separate entity, Otis has reformed its management incentive structures, aligned its strategy strongly against growth and is focussing in on latent cost efficiency opportunities in procurement, overheads, debt and tax structures. Otis's 2.1M unit service portfolio is ~25% larger than the next biggest and has a peer-leading 93% retention rate, yet it has a huge opportunity to bring back in-house Otis equipment serviced by others, especially independents and especially in China. We believe the market underestimates the significance and scale of the improvement that can be realised with a tight focus and well incentivised management. But even if the market's expectation is right and the outlook more modest, Otis is clearly mispriced in our view. It trades at 20-30% discount to its European peers on most pricing metrics despite having a larger transformation opportunity and more resilient business mix.

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