DIAMOND HILL

INVESTED IN THE LONG RUN

Small Cap Monthly Musings

Where the Rubber Meets the Road

Mar 2024

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What are the implications of increased adoption of electric vehicles (EVs)? For businesses involved in any way with the automotive industry/complex or those looking to invest in those businesses, this is a critical question that companies have grappled with for years.

One thing we continue to emphasize in our evaluation of businesses — and a characteristic that excites us — is when companies are positioned not just to withstand changes or disruptions within their industry but can benefit from them. Some impacts may be evident. For example, upgrades to the electrical infrastructure, such as charging station build-outs and electrical utility investment. However, some areas may be less intuitive, such as the fact that EVs tend to wear through tires 20-50% faster than internal combustion engine vehicles or the fact that EVs are less likely to be drivable after an accident and other salvage nuances due to vehicle design.

These observations get us excited about two positions in our Small-Cap portfolio that may not seem like businesses well-suited to benefit from the increased adoption of electric vehicles. Let's explore them.

A recent addition to the portfolio was specialty chemical company Orion, which is focused on producing carbon black, a colorant and reinforcing filler in tires and other rubber products. Carbon black is a niche within specialty chemicals and can deliver reinforcing properties, enhanced product life, electrical conductivity, and intense black color, among other things. End markets for carbon black are roughly 70% tires, 20% other rubber products (such as belts, hoses, etc.) and 10% specialty products — the most profitable area.

The type of carbon black that goes into tires is referred to as rubber carbon black (RCB), and the key demand drivers are miles driven and OEM (original equipment manufacturing) production. An additional driver supporting demand is increased adoption or penetration of electric vehicles, which wear through tires faster than a traditional internal combustion engine (ICE) for two reasons: (1) EVs tend to be heavier than ICE vehicles, putting additional wear on tires; (2) Higher engine torque, which causes more rubber to come off the tires when the vehicle starts moving.

Orion is the #3 player within the RCB industry, and we think they are well positioned with a little over 80% of their RCB business in the Americas/EMEA. RCB is not super conducive to shipping, so being close to tire manufacturers is a positive from a pricing perspective. This makes Orion well-positioned to benefit from multiple significant reshoring announcements that we've seen from tire manufacturers after the supply chain disruptions of the past couple of years.

Another portfolio company that stands to benefit from the potential increased adoption is Miller Industries, the world's largest manufacturer of towing and recovery equipment. Miller is the dominant player in the industry with its product breadth, distribution capabilities, and engineering/R&D know-how.

One of the demand drivers for Miller is miles driven — the more miles driven, the more road incidents that require a tow or recovery. In terms of EVs, the frequency of crashes may decline slightly as enhanced driving features continue to be embedded into vehicle design. However, the severity is likely to increase as relatively minor incidents can quickly render EVs un-operable. In addition, there is an element to the design of many EVs where the movement of tires — as would be necessary in a traditional towing structure — creates unintended electrical generation. This has an upstream effect of damaging the vehicle's battery and motor, so for fully un-operable incidents, there would be an increased need for flatbed towing — a potential demand driver for Miller Industries — ideal for stabilizing the tire base.

As of 29 February 2024, Diamond Hill owned shares of Orion Engineered Carbons SA and Miller Industries Inc.

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