Neuberger Berman Sustainable Investing Challenge, Team 22
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Conclusion (SKFRY)

SKF (SKFRY) is a compelling investment due to its upcoming restructuring and strong positioning across manufacturing, supplying, and servicing for rotating equipment. With a century-long legacy, SKF stands as a global leader active in over 130 countries, partnering with 17,000 distributors, and supporting over 40 industries, expecting to achieve 5% revenue growth in FY25 from organic sales and functions at 3% higher operating margins compared to the industry average. Additionally, SKF's expertise in high-margin lubrication, RecondOil, and remanufacturing services contribute to recurring revenue streams and customer retention. Our investment thesis centers on SKF's streamlined emphasis on industrial growth, diversified revenue channels, and commitment to sustainability, which collectively underpin its long-term growth potential and value creation for shareholders.[1]

Company Overview

SKF is a Swedish company specializing in the manufacture and supply of bearings, seals, lubrication systems, and related services. The company operates under two segments, Industrial and Automotive, which account for 70% and 30% of revenue respectively. The pending separation of the Automotive business positions SKF as a pure-play industrial provider. Geographic mix for its Industrial Business is India and Southeast Asia 8%, China and Northeast Asia 23%, The Americas 29%, Europe, Middle East, and Africa 40%.

Competitive Advantage

SKF dominates the ball bearings market through their precision engineering and innovative frictionless designs, enabling superior system efficiency and maintenance even under extreme conditions. Their 2021 acquisition of EFOFLEX, a specialized lubrication and oil filtration systems manufacturer, led to the launch of RecondOil. As they move further into expanding their global industrial lubrication market position, in Q3 2024 they acquired John Sample group, a lubrication and flow management company whose primary client base is in the high-growth regions of Southeast Asia and Oceania.

India emerges as a particularly compelling market, where SKF has demonstrated revenue growth of 15%, significantly above the underlying market average of 7%.

The company's 2023 strategic framework emphasized sustainability, digitalization, regionalization, and electrification, positioning them at the forefront of industry transformation. By digitizing manufacturing operations, SKF has created an integrated value chain that enhances operational efficiency and customer responsiveness. Their

[1]The highest level reward when earned by remaining in the top 1% of all companies assessed by one of the world's most trusted providers of sustainability ratings.

sustained investment in global plant infrastructure has expanded regional capabilities, creating strategic advantages for future growth.

SKF maintains significant competitive barriers through both capital requirements and technological leadership. They maintain margin resilience over each quarter, regardless of sales volumes (Exhibit A, I). The high costs of steel and manufacturing create natural entry barriers, while SKF's circular economy approach - achieving 90% recycled material in bearing production - provides cost advantages. Their R&D investments, amounting to 3.5% of revenues, significantly exceed competitor Timken's 0.8%, demonstrating their commitment to maintaining technological superiority in the industry. Additionally, SKF allocates around 5.5% of its sales to capital expenditures, with an average payback period of 3-5 years, further strengthening its technological leadership and operational efficiency.

SKF as a Strong Buy in Industrial Bearings Amid Industry Growth

The ball bearing industry plays a fundamental role in manufacturing, enabling reduced friction across various machinery. Bearings are essential for automotive, industrial, and aerospace applications, with increasing demand driven by technological advancements, automation, and growing needs in emerging markets. The global bearings market is expected to grow at a 8.66% CAGR through 2032 (Exhibit B). With an estimated SEK 465–485 billion market value, bearings are positioned as key components in energy-efficient, high-performance automation systems.

SKF holds approximately 25% of the industrial bearings market, positioning it as a leader in this high-potential segment. With industrial bearings contributing 71% of SKF’s net sales and 88% of its operating profit in 2023, SKF’s focus on industrial applications aligns with market trends particularly excelling in its agriculture, food & beverage, and railway divisions. The agriculture division achieves 13.5% annual growth rate, whereas the market average is 5%. Recent initiatives, like the opening of a new factory in Monterrey, Mexico, reinforce SKF's commitment to expanding its global footprint while responding to consumer lifecycle needs contribute to market revenue growth.

SKF remains a market leader due to its R&D initiatives across these categories. SKF outpaces its competitors by holding a ~3.5% ratio of R&D expenditures to sales with a goal of increasing by 50% by 2030, exceeding competitors by upwards of 5%. The company allocates 62% of its R&D budget to sustaining core products and 25% to developing new ones, aiming to generate 75% of profits from innovation.

SKF’s decision to divest its automotive division marks a strategic shift to focus on its higher-margin, market-leading industrial segment (Exhibit I), aiming to increase shareholder value. The industrial sector's profitability outpaces automotive, with SKF’s industrial adjusted operating margin reaching 16.4% compared to automotive’s 6.0% (Exhibit C). By

reducing exposure to the highly competitive automotive market, SKF can channel investments into industrial innovation, such as its 3D-printed axlebox for railways and specialized magnetic bearings, aligning with its long-term growth objectives.

The Role of Oil Regeneration in Industrial Efficiency and Cost Reduction

Acquired by SKF in 2020, RecondOil uses its patented Double Separation Technology (DST) to purify used lubricants down to the nano level, enabling the continuous regeneration and purification of industrial oils for indefinite reuse (Exhibit D). This technology enables the circular use of oil, reducing the need for frequent oil changes and minimizing waste, which aligns with SKF's sustainability goals. By enabling industries to reuse oil multiple times without degradation, DST contributes to lowering CO_2 emissions and reducing the environmental footprint associated with industrial lubrication. There is also a major cost benefit of oil regeneration, particularly in industries dependent on large volumes of industrial lubricants, such as manufacturing, heavy industry, and marine applications. Oil accounts for only 5% of the average maintenance budget in these industries, but affects 40% of maintenance costs. By enabling closed-loop oil systems, RecondOil helps SKF's clients reduce dependency on fresh oil, lower waste disposal costs, and contribute to CO_2 reduction goals (Exhibit E).

SKF's patented Solid Oil technology is a unique bearing lubrication process designed to extend the lifespan of bearings and reduce maintenance needs, particularly in harsh or moisture-rich environments. This process involves embedding a polymer matrix, which is saturated with lubricating oil, directly within the bearing. With Solid Oil, there is no need for routine relubrication, as the embedded oil continuously lubricates the bearing throughout its life. This reduces maintenance costs and minimizes the risk of equipment downtime due to lubrication failures. In one example involving a steel mill, the implementation of Solid Oil led to significant improvement: mean time between bearing failures increased from less than one year to over five years, generating total savings of $136,730 and delivering a 378% return on investment within 30 months. Such results underscore the tangible benefits of SKF's technological and strategic innovations.

SKF's Circularity as a Path to Net Zero by FY2050

SKF integrates sustainability and circularity at the heart of its core business model, ensuring these principles drive both operational efficiency and long-term value creation. By designing products with extended life cycles and prioritizing remanufacturing and recycling, SKF reduces waste and resource consumption.

A key component of this approach is their bearing remanufacturing program, which offers several benefits, including environmental impact reduction, cost effectiveness, and lead time improvements. Remanufacturing reduces 90% of the energy required to produce a new bearing, significantly cutting carbon emissions and conserving natural resources. By

extending service life up to three times, remanufacturing lowers life-cycle costs and reduces the need for maintaining large inventories of replacement parts. For example, a bearing typically replaced after three years can be remanufactured twice, lasting up to nine years (Exhibit F). This process also delivers 50–80% cost savings compared to new bearings and minimizes equipment downtime, enhancing efficiency.

Approximately 90% of SKF's R&D portfolio targets high-growth sectors like electric vehicles and aerospace, further emphasizing reduced environmental impact. Recent innovations include a bearing with a 70% reduced CO_2 footprint and a partnership with Voestalpine to create a prototype bearing from hydrogen-reduced steel. SKF works closely with global initiatives like ResponsibleSteel and engages with suppliers to decarbonize and embed circular economy practices into the supply chain.

SKF aims for net-zero greenhouse gas emissions across its value chain by 2050. By 2023, SKF had achieved a 41% reduction in targeted emissions, demonstrating strong progress toward its 2050 goals (Exhibit G). Currently, 64% of the electricity SKF uses comes from renewable sources, with a roadmap to reach 100% renewable electricity by 2030. The company has earned an ESG risk rating of 15.9 from Sustainalytics, underscoring its leadership in sustainability. Key initiatives include transitioning to 100% renewable electricity through RE100 and banning fossil fuel investments. Through these efforts, SKF demonstrates that embedding a circular economy into its operations not only supports environmental sustainability but also reinforces product performance and profitability.

Financial Valuation

Due to SKF's strategic portfolio alignment highlighting its strong operating margins (14% in Industrial, 8% in Automotive), consistent profitability and cash flow generation, and commitment to long-term ESG initiatives, SKF represents a compelling investment opportunity. The planned separation of businesses in 2026 should unlock additional shareholder value through improved segment-specific focus and capital allocation.

Our FY29 target price of SEK 270 is based on a DCF valuation, capturing SKF's transition to a pure industrial player after the automotive segment separation in 2026. Our bull case of SEK 305 assumes stronger growth (16%) and enhanced operating margins (15%), while the bear case of SEK 220 reflects more conservative growth (10%) and margin assumptions (12%) (Exhibit J).

The base valuation assumes 14% revenue growth, building upon the industrial bearings market's projected 8.6% CAGR through 2032. Additional growth drivers include SKF's industrial segment outperformance (+2%, evidenced by railway and agriculture divisions exceeding market growth rates by 3-8.5%), automotive separation benefits (+1.5% through improved capital allocation), emerging market penetration (+1%, supported by India's demonstrated 15% growth versus 7% market average), and sustainability leadership

premium (+0.9% from circular economy initiatives). This growth assumption, combined with targeted 14% margins, is supported by SKF's R&D investment exceeding competitors by 2.2% and their remanufacturing program achieving 50-80% cost savings while tripling product life cycles.

Using an 8.5% WACC with 2% terminal growth, our model suggests the current share price of SEK 206 significantly undervalues the transformation potential. Cash deployment maintains the 53% dividend payout ratio, with the remaining 47% strategically split between debt reduction (35%), future potential industrial acquisitions (35%) and selective share buybacks (30%) to optimize the capital structure ahead of the separation.

Risk Analysis

SKF is navigating a complex digital transformation, moving from a traditional manufacturing model to an integrated, globally-optimized planning approach. The digital transformation to create a "digital twin" across 40 installations and 800,000+ SKUs introduces execution risk, requiring fundamental changes to organizational processes and systems that could disrupt existing operations.

The company faces critical market risks, particularly in its core geographies. The planned automotive division separation by 2026 creates uncertainty around future market positioning, particularly crucial given weakening demand in key growth markets like China and Northeast Asia (Exhibit H). The company's stable operating margins around 13% (Exhibit A), while encouraging, may face pressure during this transition.

SKF must balance short-term performance with long-term transformation investments. While cost management and portfolio optimization support current performance, sustained investment in digital capabilities and R&D is essential for future competitiveness. The challenge lies in funding these strategic initiatives while managing restructuring costs and maintaining target operating margins above 14%.

References

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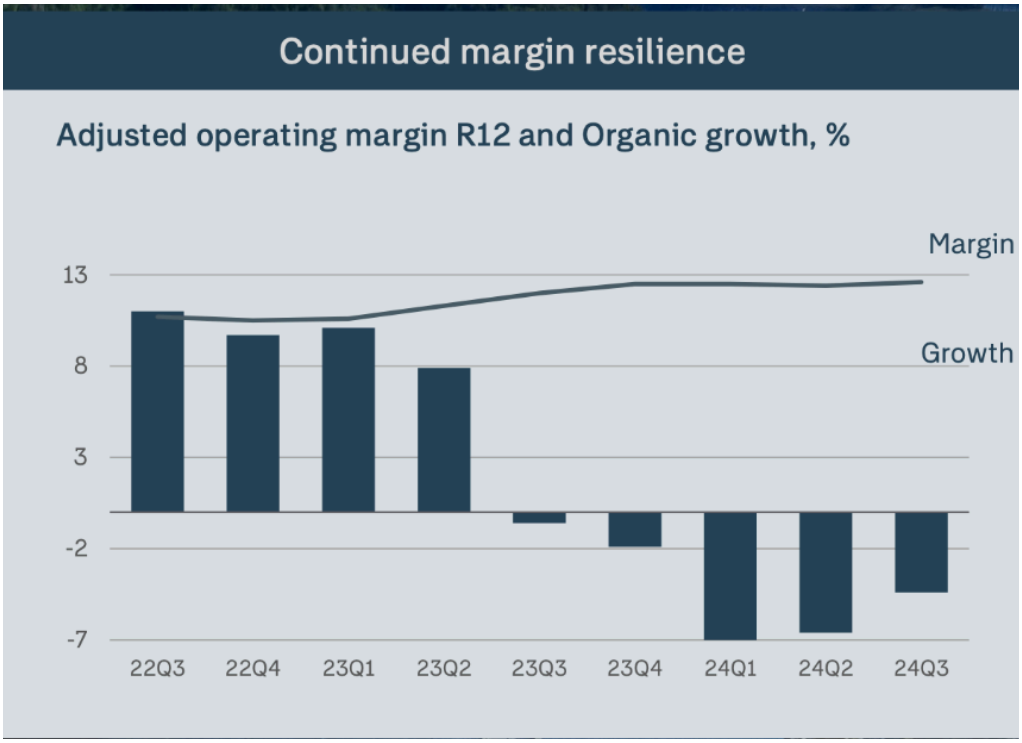
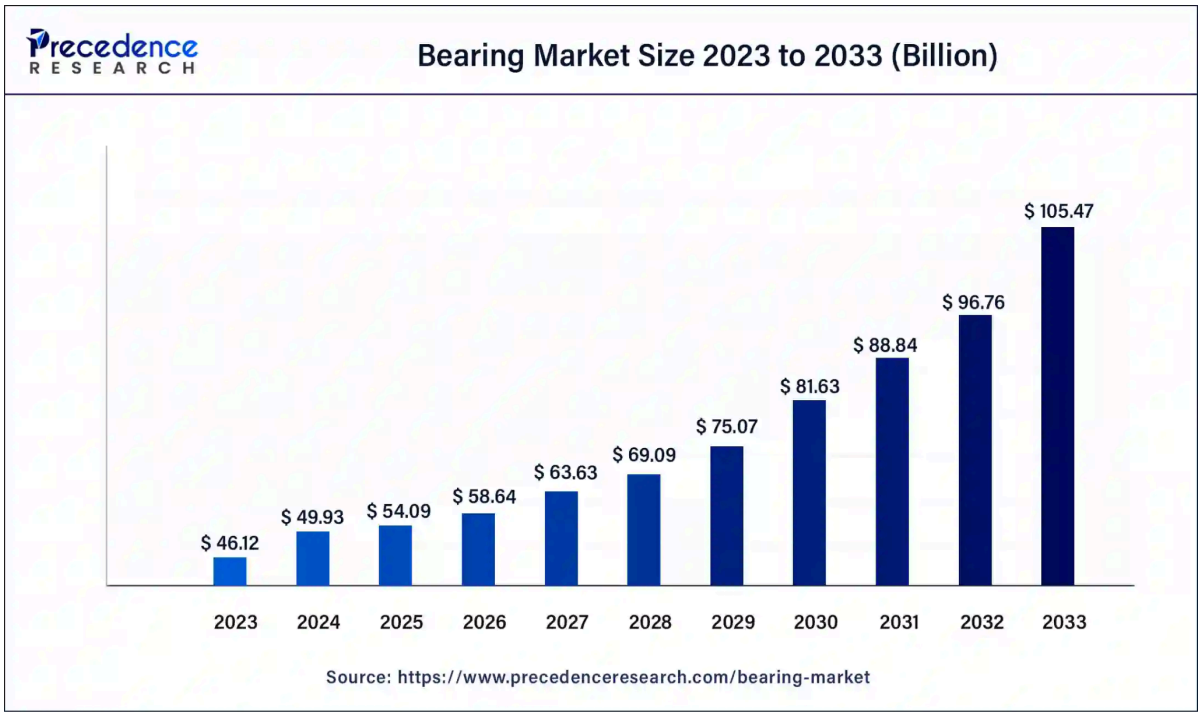
Appendix

Exhibit A



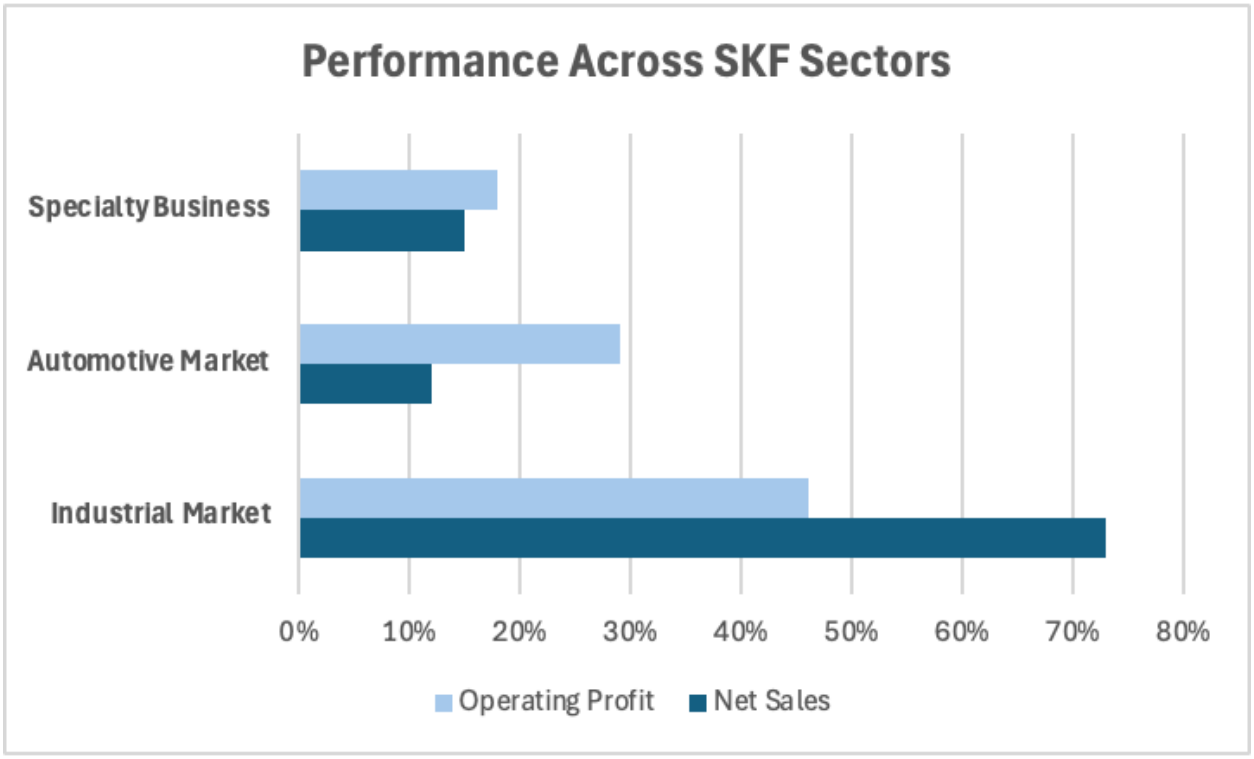
SKF experiences consistent margin growth through weak markets.

Exhibit B



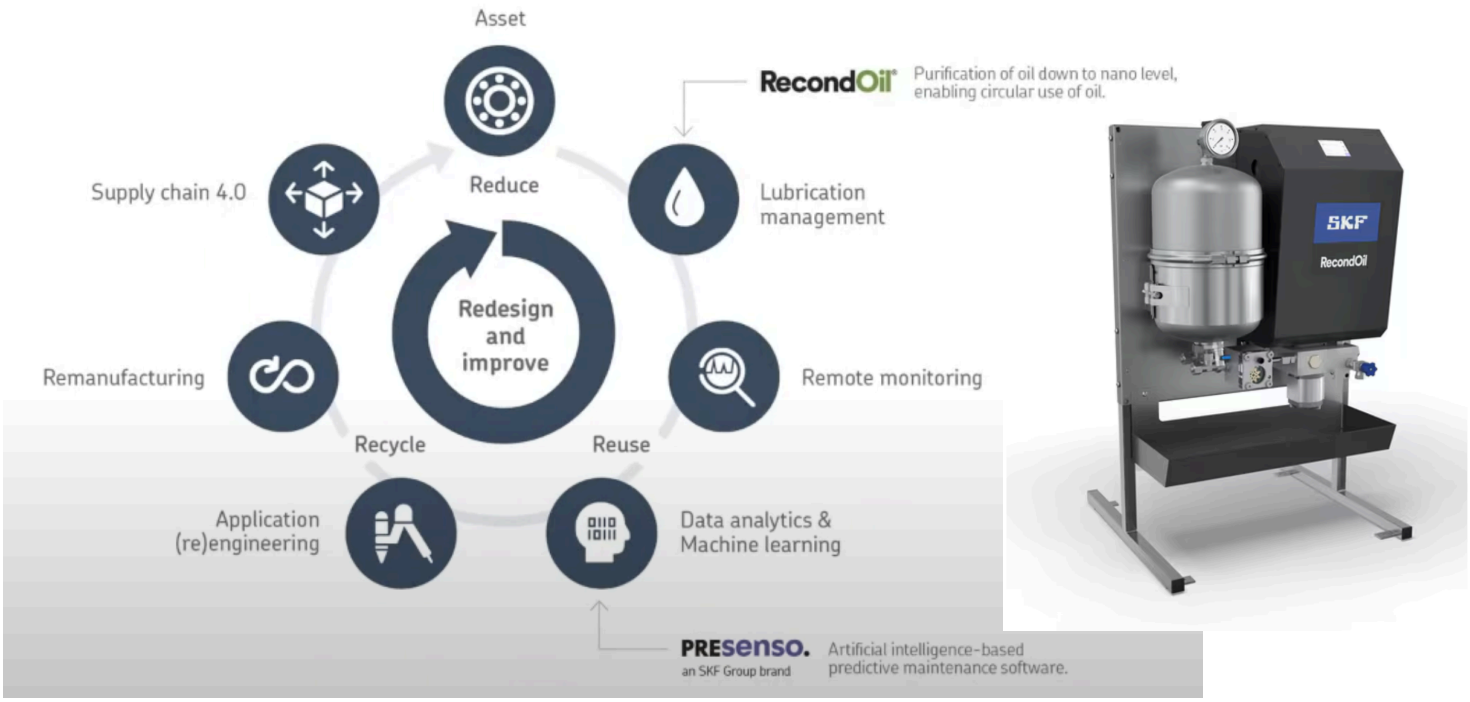
Precedence Research: Bear Market Growth Expectation 2023 to 2033 (Billion)

Exhibit C



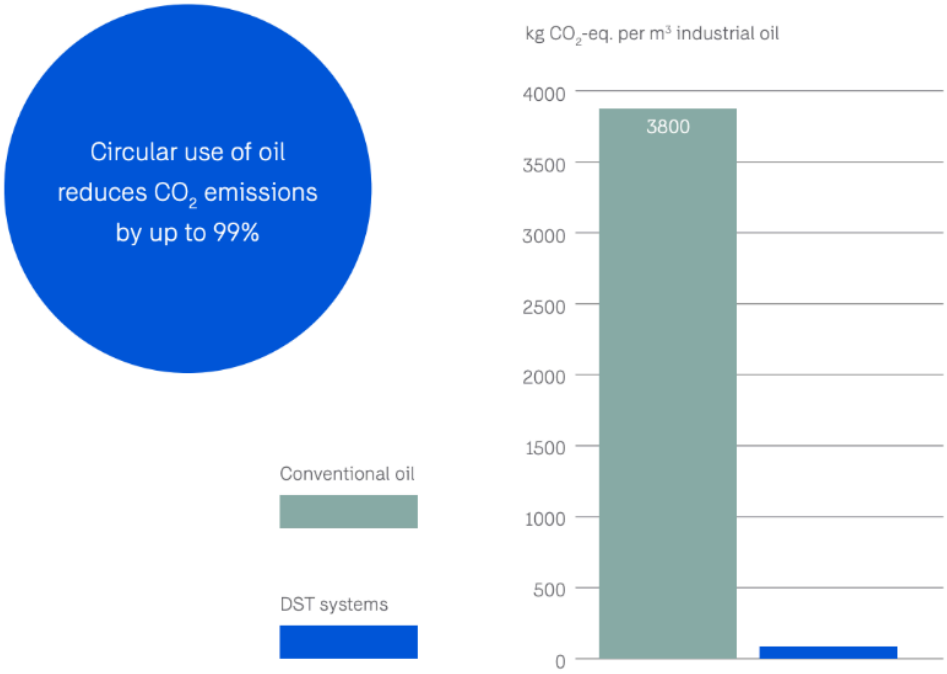
SKF Performance Metrics Across Segments

Exhibit D



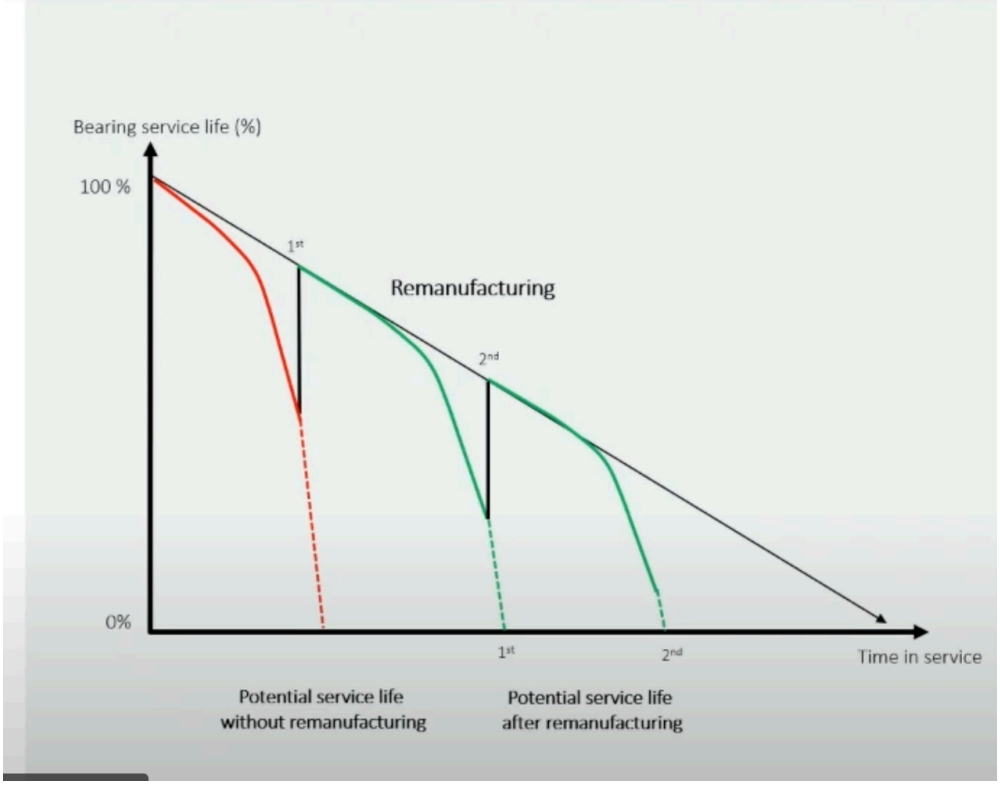
RecondOil Process demonstrating recycling capabilities

Exhibit E



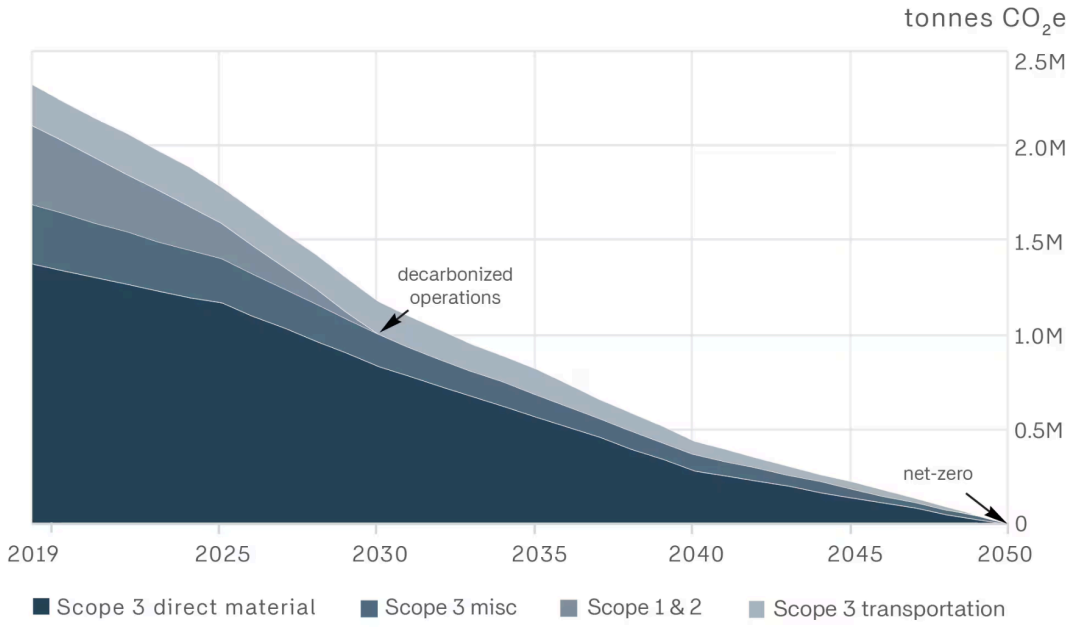
Emission Reduction due to oil cleaning

Exhibit F



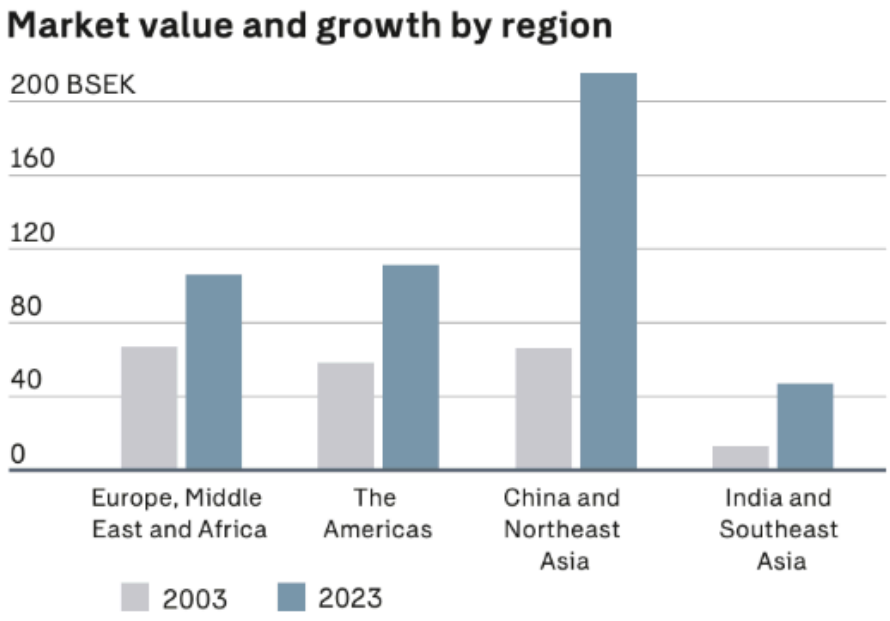
Bearing Life Cycle Extension due to Remanufacturing

Exhibit G



SKF has Science Based Target initiatives (SBTi) in place to reach Net Zero by 2050

Exhibit H



Ball Bearings Market Growth By Region

Exhibit I

Segment information – quarterly figures[1)]

MSEK unless otherwise stated

Industrial	Q4/22	Q1/23	Q2/23	Q3/23	Q4/23	Q1/24	Q2/24	Q3/24
Net sales	18,111	18,892	19,114	18,037	17,350	17,487	17,943	16,537
Adjusted operating profit	2,152	3,182	3,025	2,462	2,611	2,867	2,919	2,486
Adjusted operating margin, %	11.9	16.8	15.8	13.6	15.0	16.4	16.3	15.0
Operating profit	1,763	3,108	2,633	2,081	1,913	2,644	2,131	2,241
Operating margin, %	9.7	16.4	13.8	11.5	11.0	15.1	11.9	13.6
Assets and liabilities, net	50,387	53,510	56,247	54,550	50,420	55,390	55,243	53,308
Registered number of employees	35,965	35,542	35,411	34,837	34,017	33,722	33,235	32,876

Automotive	Q4/22	Q1/23	Q2/23	Q3/23	Q4/23	Q1/24	Q2/24	Q3/24
Net sales	7,250	7,657	8,009	7,734	7,088	7,212	7,663	7,155
Adjusted operating profit	390	296	589	494	318	436	405	335
Adjusted operating margin, %	5.4	3.9	7.4	6.4	4.5	6.0	5.3	4.7
Operating profit	306	271	580	486	12	349	358	285
Operating margin, %	4.2	3.5	7.2	6.3	0.2	4.8	4.7	4.0
Assets and liabilities, net	15,255	15,363	16,018	15,778	14,611	15,535	15,929	15,540
Registered number of employees	4,049	4,031	3,951	3,966	4,089	3,968	3,983	3,918

1) Previously published figures for 2022 and 2023 have been restated to reflect change in responsibilities for factories and Group functions in accordance with new organizational structure.

Exhibit J