SAIL THROUGH, OPTIMIZE, OR TRANSFORM?

HOW TO EMERGE AS A WINNER FROM THE NEXT RECESSION

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OLIVER WYMAN

The manufacturing industries market has grown for the past 10 years. Leaders in machinery and engineering firms grew accustomed to volatility and an unprecedented level of uncertainty and risk. But now – for the first time in a decade – lead indicators show an imminent downturn risk. The downturn will be different than previous ones and might hold a cocktail of shocks. However, most firms enter the potential downturn from a position of strength – certainly stronger than it was the case in 2008 – and could emerge as winners if they take the right action.

Since the financial crisis in 2008-2009, the market for mechanical engineering firms has grown steadily. With the exception of a few minor dips, the industry has experienced an economic upswing of unprecedented length. Despite all the volatility, uncertainty, and ambiguity, growth in machinery and engineering companies has been relatively steady. But now a potential downturn has become more imminent.

RECESSION ON THE HORIZON

88%

of manufacturing industry firms are currently in a good position

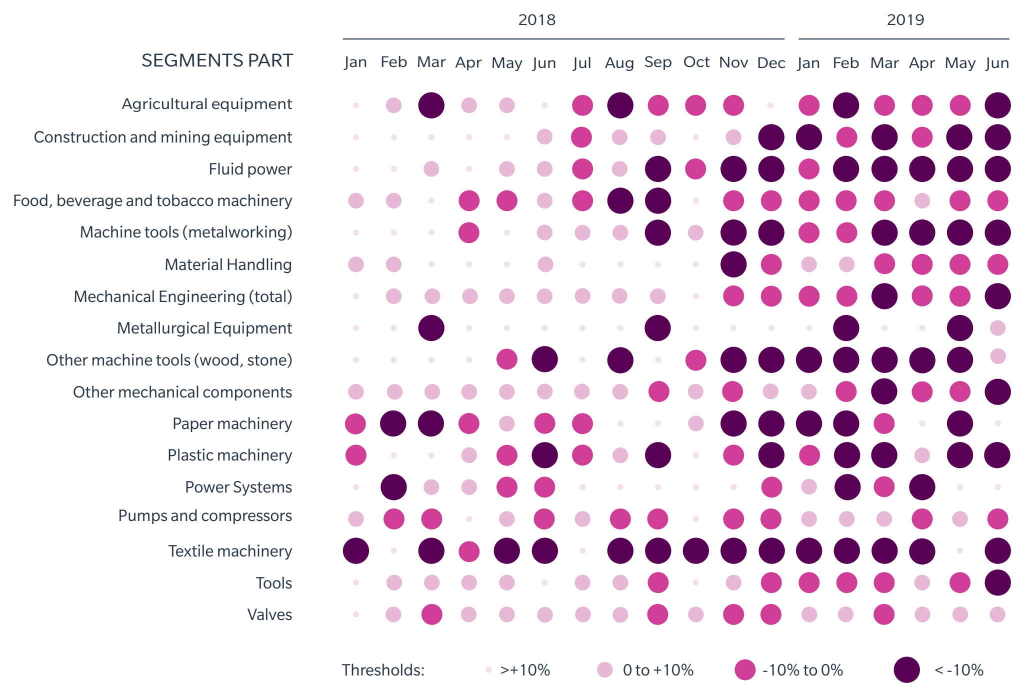
While macroeconomic indicators are still mixed, they have begun to show a downward trend in the past months: the German IFO index has dropped in June 2019 to the lowest level since November 2018. Europe is up a bit in the second quarter of 2019 but the US purchasing manager index dropped for the third month in a row, to its lowest level in three years.

Oliver Wyman has built a lead indicator to predict potential recessions in mechanical engineering. While the indicator for Germany has been in the neutral-to-"green" range since 2009, it turned "red" in the last quarter of 2018. As the lead-time for this indicator is four quarters, it indicates a downturn for the sector as a whole in the second half of 2019. Some early-cycle subsectors are already experiencing a sharp decline in new orders: for example, plastic machinery, textile machinery, and machine tools all saw a drop-in demand in excess of 10 percent. (See Exhibit 1.)

THE NEXT RECESSION WILL BE DIFFERENT

The downturn in 2008-2009 was harsh but relatively short for most of the industry: the drop-in demand was severe, but governments and central banks acted decisively, and demand rebounded quickly. Companies that did cut their cost in the short term and kept their core group or employees weathered the storm reasonably well.

Exhibit 1: Monthy order intake German mechanical engineering segments (yoy development)



Source: Oliver Wyman analysis

However, this time the recession will be different for three reasons:

Firstly, a downturn will accelerate the underlying shift in demand that is driven by structural changes like electro-mobility or digitization in many subsectors. For example, the automotive industry is likely to cut capital expenditures for machinery for conventional combustion engines even further in a downturn to preserve investments in e-mobility. Manufacturers affected by these accelerated market shifts will suffer disproportionately.

Secondly, trade barriers are likely to rise further in a downturn, disrupting global supply chains and complicating sales for machinery firms, which rely heavily on export sales.

Lastly, the ability of governments and central banks to help in a downturn has decreased significantly as public debt has grown and interest rates have little room to drop further. In an extreme scenario, the stability of the Euro or the global financial system might be tested.

So, anything from a mild wind to the perfect storm seems to be possible.

COMPANIES ARE STRONG AND HAVE SIGNIFICANT UNTAPPED POTENTIAL

That said, companies currently find themselves in a strong position. Thanks to low interest rates, there's significant financial headroom, equity has been up built over 10 years of growth, and profitability is back to 2007 levels. (See Exhibit 2.)

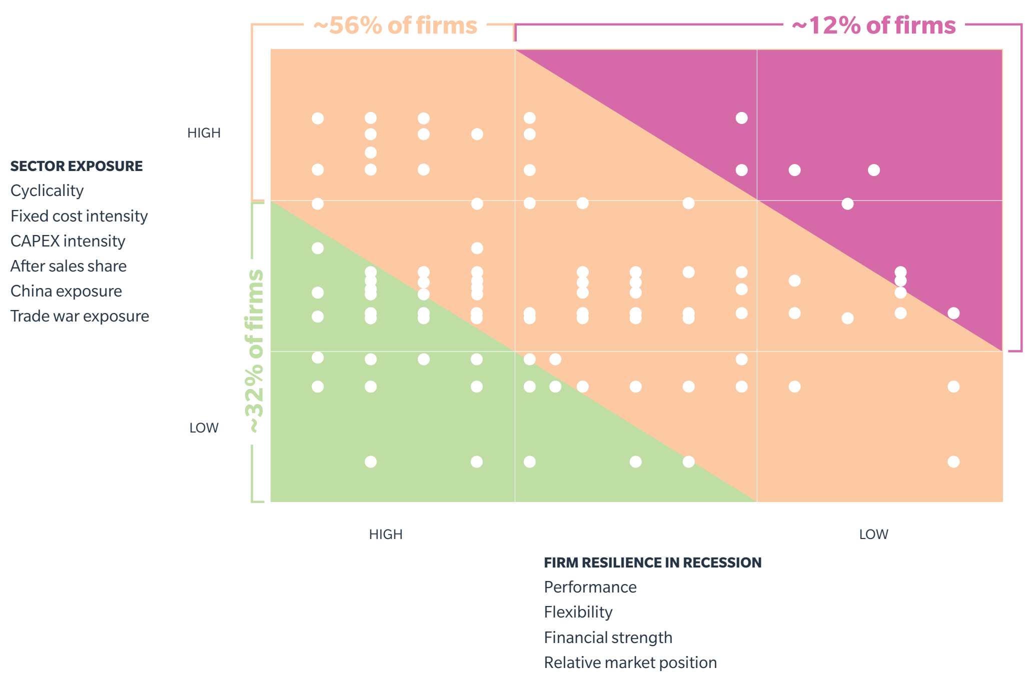
At the same time, there is significant room for reduced complexity, better performance, lower cost and more flexibility. Because many companies have been busy managing growth, structural cost reduction has been postponed in many cases, and the move to low-cost countries and localization of supply chains has not moved along as fast as planned. In many cases, IT platforms date back to the 1990s and digitalization of processes are still in the pilot stage.

HOW TO EMERGE AS A WINNER

Industry aspirations are high: A survey by Oliver Wyman indicates that 91 percent of executives aim to emerge stronger from the next downturn.

And for those who act decisively, the returns are likely to be significant. On average, companies that actively undertook a transformation of their business in the

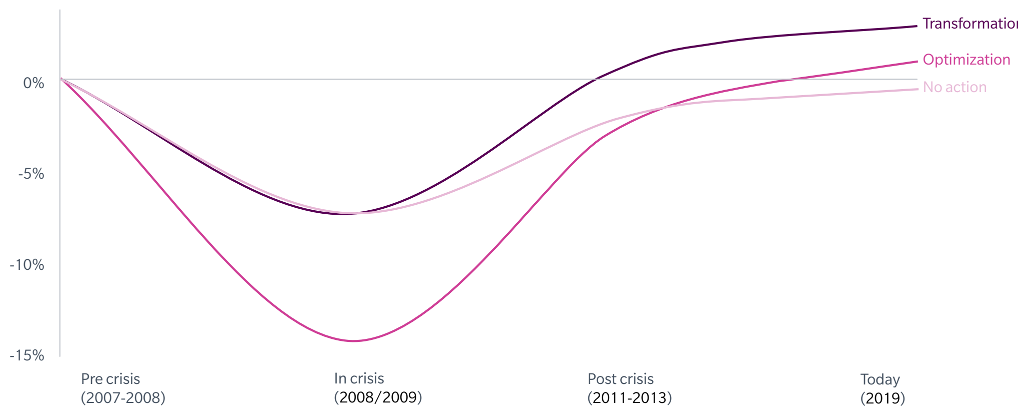
Exhibit 2: Starting situations differ strongly by manufacturing firm (*dots represent companies)



Source: Oliver Wyman analysis

Exhibit 3: Exhibit 3: Action creates a return

Adj. EBIT-margin development for peer group in the same industry segment
Percentage point difference, sample of 100 public manufacturing firms during 2008-2009 recession



Source: Oliver Wyman analysis

2008-2009 recession saw a 4 percent EBIT gain, as compared to those who took a passive approach. (See Exhibit 3.) Those companies that deployed traditional cost-cutting measures came out in between.

What companies should do in order to prepare for the downturn very much depends on the situation they are in. "Sail Through", "Optimize", and "Transform" are typical archetypes for strategies in a recession. (See infographic for details and case examples.) There are certainly a number of generally good practices such as full transparency, securing financing and cash, having multiple contingency plans ready, and being aware of how recession-proofed your management team is. Having taken those steps, companies should decide on their recession strategy and aim high to emerge as a winner!

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THREE DIFFERENT APPROACHES TO WIN IN A RECESSION

SAIL THROUGH

WHEN?

Strong market position
Well prepared for future trends
Short & shallow downturn expectation
Very solid financial position

WHAT?

No fundamental changes

HOW TO WIN?

Good judgement
Grab opportunities

EXAMPLE: MANUFACTURER OF COMPRESSORS FOR THE OIL & GAS INDUSTRY. Sail through meant to temporarily reduce leased labour and refocus on planned internal projects.

SITUATION

Steep decline in demand (from 100 to 6 units per week)

ACTION

Reduction of leased labour to zero
Kept core employees and implemented planned internal projects

OUTCOME

Emerged from downturn with improved operations
Fast ramp up after recession

OPTIMIZE

WHEN?

Greater financial restrictions
Short- to mid-term need for action
Uncertainty about downturn length

WHAT?

Traditional cost cutting
Some structural changes

HOW TO WIN?

Early and comprehensive action program
Address structural issues

EXAMPLE: CONSTRUCTION AND BUILDING MACHINES.
Optimize meant a full restructuring program with short- and long-term measures.

SITUATION

Market leader
Sector strongly hit by financial crisis
Weak footprint in China
Inefficient operations

ACTION

Cash generation
Capacity reduction
Product cost reduction (-30%)
Supply chain push -› pull
Focus on core value add
Implementation faster than competitors

OUTCOME

Return to profitability
Outgrowing competitors
Strenghtened leadership position

TRANSFORM

WHEN?

Uncertainty about downturn length & depth
Game charger opportunity
Solid financial position

WHAT?

Strategic and structural repositioning
Digital transformation
M&A

HOW TO WIN?

Clear strategic target picture and transformation plan
Buy-in from management and stakeholders
Early and decisive action

EXAMPLE: AUTOMOTIVE EQUIPMENT SUPPLIER. Transform meant to reduce dependency on one customer industryand adapt corporate structure.

SITUATION

Market leader
Stretched after series of acquisitions
Strong cyclicality
Slowing OEMs investments
Financial stretch

ACTION

Divestments
Redesign of core business
Refinancing
M&A

OUTCOME

Widened gap to #2
Double digit organic growth
3x EBIT