SAIL THROUGH, OPTIMIZE, OR TRANSFORM?

HOW TO EMERGE AS A WINNER FROM THE NEXT RECESSION

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OLIVER WYMAN

For the past 10 years, the manufacturing sector has enjoyed steady growth, with manufacturers becoming accustomed to and adept at managing volatility, unprecedented levels of uncertainty, and risk. But now – for the first time in a decade – leading indicators are pointing to the risk of an imminent downturn. This recession is likely to be different than previous ones and may deliver a cocktail of shocks. However, firms are entering the potential slump from a position of strength – certainly stronger than in 2008 – and, if they take the right actions, could emerge from the recession as even stronger winners.

Since the financial crisis in 2008-2009, the market for manufacturing firms, including manufacturing equipment and machinery makers as well as actual manufacturers, has grown steadily. Apart from the brief market correction in late 2015 and a few minor dips, the industry has experienced an economic upswing of unprecedented length. Despite all the volatility, uncertainty, and ambiguity, growth rates at manufacturers have remained relatively stable. But now, the sector is facing a possible downturn, one that is growing more and more imminent.

88%

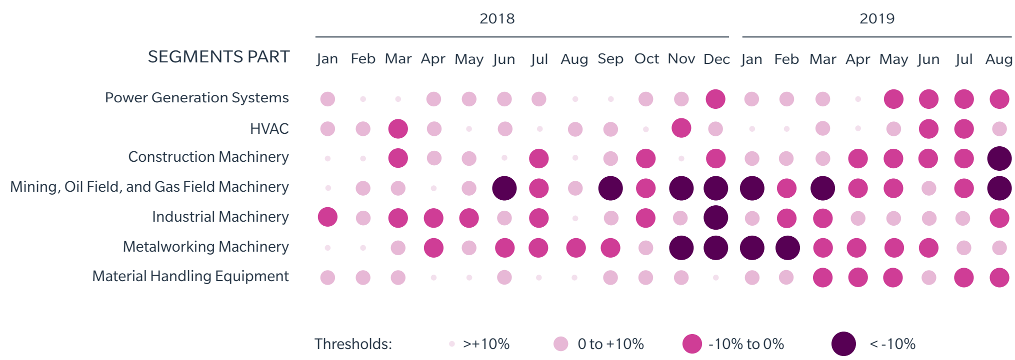
of manufacturing industry firms are currently in a good position

RECESSION ON THE HORIZON

While macroeconomic indicators in North America are still mixed, they have begun to show a downward trend in the past months: Incoming orders in the United States machinery segment dropped considerably in the second quarter of 2019. And in a sign of an imminent downturn, the US manufacturing purchasing managers' index (PMI) dropped for the fifth month in a row, to its lowest level in three years. US Treasury yield curves inverted in summer 2019 – another common early indicator of a recession.

Oliver Wyman has built a lead indicator model to predict recessions in – for example – the machinery industry. While the indicator for the United States has been in the "neutral-to-green" range since 2009, it turned "red" in the third quarter of 2019. As the lead time for this indicator is roughly four quarters, it indicates a downturn in the first half of 2020, assuming no major political or fiscal stimulus. Some early-cycle sub-sectors are already experiencing a sharp decline in new orders: Specifically, mining, oil & gas machinery, and construction equipment experienced a drop in demand greater than 10 percent. (See Exhibit 1.)

Exhibit 1: Monthly order intake in the United States machinery sector (yoy development)



Source: Oliver Wyman analysis

THE NEXT RECESSION WILL BE DIFFERENT

The downturn in 2008-2009 was harsh, and the falloff in demand was severe. Governments and central banks acted decisively, but many companies were significantly impacted. It took about 18 months for demand to rebound. Those that weathered the storm reasonably well had quickly cut their costs in the short-term but kept their core workforce. This time, however, there are three macro trends that will force companies to rethink their approach:

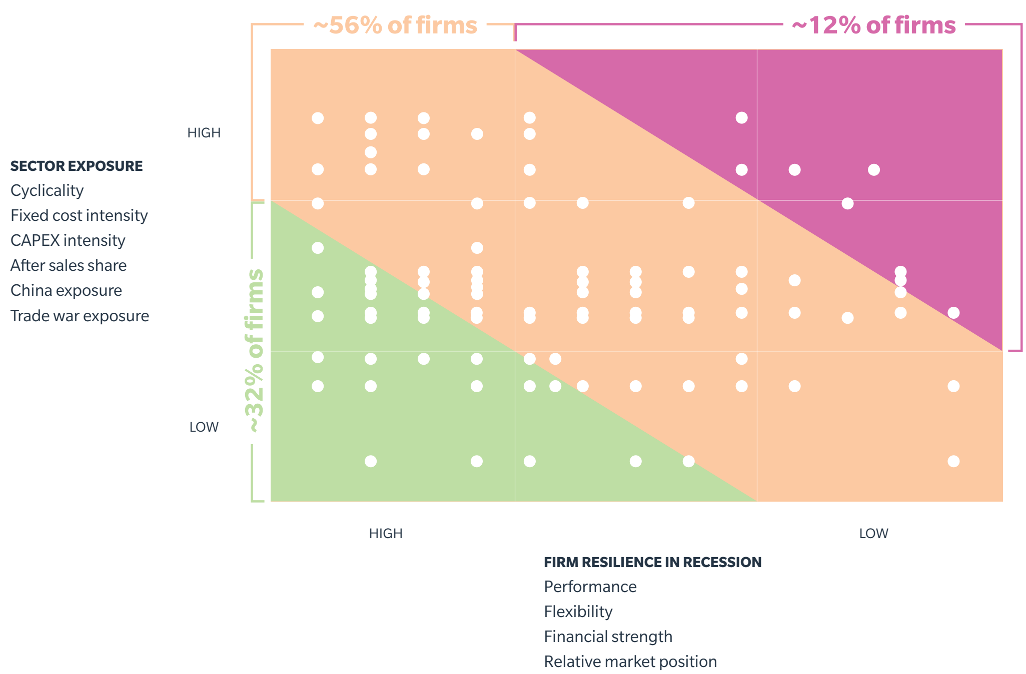
Firstly, a downturn will accelerate the underlying shift in demand that is driven by structural changes such as e-mobility and digitization in many sub-sectors. For example, the automotive industry is likely to cut capital expenditures for manufacturing equipment for conventional combustion engines even further to preserve investments in e-mobility. Manufacturing companies affected by these accelerated market shifts will suffer disproportionately.

Secondly, political uncertainty created by the current US administration further fuels the fire: The trade war with China could escalate in a downturn. Prolonged negotiation of trade agreements such as the United States-Mexico-Canada Agreement (USMCA) and the Trans-Pacific Partnership (TPP) could disrupt global supply chains and complicate sales for manufacturing firms, which rely heavily on exports.

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

Out of the many possible scenarios, two seem to be most probable: The first scenario – which we think the most likely – would be a global recession and market correction in combination with a targeted slowdown within the US manufacturing sector. The Trump administration will certainly take action to postpone any

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



Source: Oliver Wyman analysis

recession symptoms until after the elections in late 2020. However, we believe that some form of contraction in the US manufacturing industry will be inevitable. The second scenario could be a deep global recession, driven by poor implementation of countermeasures in the US together with a significant slowdown in Europe and the rest of the world. This could be very similar to 2008, where years of economic softening – combined with the lingering impacts from the slowdown in 2001 – created a toxic mix. In such scenario, US manufacturing would face a major demand reduction, and the consequences could be severe.

COMPANIES ARE STRONG AND HAVE SIGNIFICANT UNTAPPED POTENTIAL

That said, companies currently find themselves in a strong position. Thanks to low interest rates, there is 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 greater 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 is still in the pilot stage.

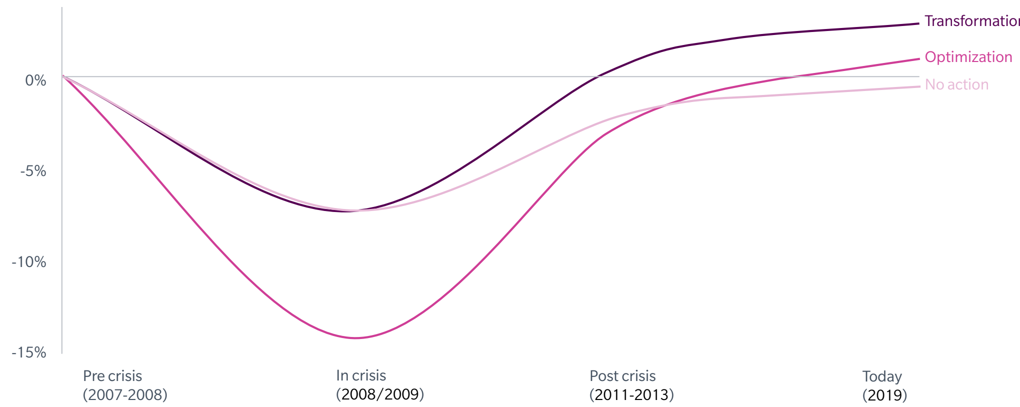
HOW TO EMERGE AS A WINNER

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 2008 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 the middle.

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

What companies should do in order to prepare for the downturn depends very much on their situation. There are certainly a number of good practices, such as full transparency, securing financing and cash, having multiple contingency plans ready, and having a recession-proven management team in place. 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 labor and refocus on planned internal projects.

SITUATION

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

ACTION

Reduction of leased labor 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